

UNIT EIGHT

★

BUSINESS ORGANIZATIONS

CONTENTS

36
Sole Proprietorships and Franchises

37
Partnerships and
Limited Liability Partnerships

38
Limited Liability Companies
and Special Business Forms

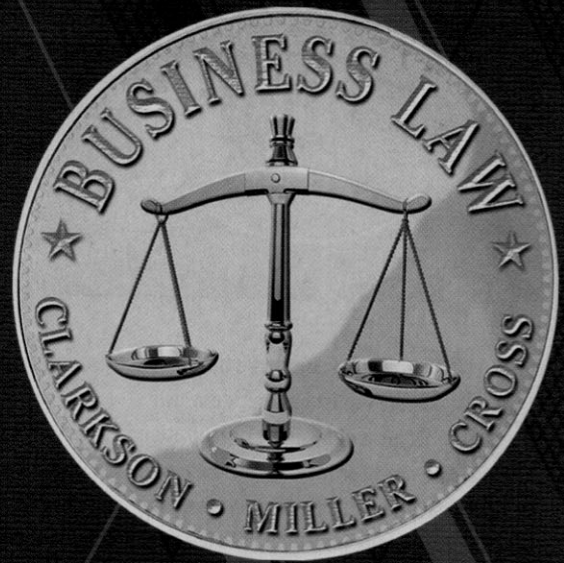
39
Corporate Formation and Financing

40
Corporate Directors, Officers,
and Shareholders

41
Corporate Merger, Consolidation,
and Termination

42
Securities Law and
Corporate Governance

43
Law for Small Businesses





CHAPTER 36

Sole Proprietorships and Franchises

Anyone who starts a business must first decide which form of business organization will be most appropriate for the new endeavor. In making this decision, the entrepreneur (one who initiates and assumes the financial risk of a new enterprise) needs to consider a number of factors, especially (1) ease of creation, (2) the liability of the owners, (3) tax considerations, and (4) the need for capital. In studying this unit, keep these factors in mind as you read about the various business organizational forms available to entrepreneurs. You may also find it helpful to refer to Exhibit 41-4 on pages 807 and 808, which compares the major

business forms in use today with respect to these and other factors.

Traditionally, entrepreneurs have relied on three major business forms—the sole proprietorship, the partnership, and the corporation. In this chapter, we examine the sole proprietorship form of business. We also look at franchises, which are widely used today. The franchise is not actually a separate organizational form. Rather, it is a contractual arrangement, and the parties to a franchise contract may use any one of several organizational forms—for example, the parties may be a sole proprietor and a corporation or two corporations.

In Chapter 37, we will examine the second major traditional business form, the partnership, as well as some newer variations on partnerships. In Chapter 38, we will look at the limited liability company (LLC), a relatively new and increasingly popular form of business enterprise, and other special forms of business.

The third major traditional form—the corporation—will be discussed in Chapters 39 through 42. We conclude this unit with a chapter (Chapter 43) discussing practical legal information that all businesspersons should know, particularly those operating small businesses.

SECTION 1 SOLE PROPRIETORSHIPS

The simplest form of business is a **sole proprietorship**. In this form, the owner is the business; thus, anyone who does business without creating a separate business organization has a sole proprietorship. More than two-thirds of all U.S. businesses are sole proprietorships. They are usually small enterprises—about 99 percent of the sole proprietorships in the United States have revenues of less than \$1 million per year. Sole proprietors can own and manage any type of business from an informal, home-office undertaking to a large restaurant or construction firm.

Advantages of the Sole Proprietorship

A major advantage of the sole proprietorship is that the proprietor owns the entire business and receives

all of the profits (because she or he assumes all of the risk). In addition, starting a sole proprietorship is often easier and less costly than starting any other kind of business, as few legal formalities are required.¹ No documents need to be filed with the government to start a sole proprietorship (though a state business license may be required to operate certain types of businesses).

This form of business organization also offers more flexibility than does a partnership or a corporation. The sole proprietor is free to make any decision he or she wishes concerning the business—such as whom to hire, when to take a vacation, and what kind of business to pursue. In addition, the proprietor can sell or transfer all or part of the business to another party at any time and does not need

1. Although starting a sole proprietorship involves fewer legal formalities than other business organizational forms, even small sole proprietorships may need to comply with zoning requirements, obtain licenses, and the like.

approval from anyone else (as would be required from partners in a partnership or normally from shareholders in a corporation).

A sole proprietor pays only personal income taxes (including Social Security and Medicare taxes) on the business's profits, which are reported as personal income on the proprietor's personal income tax return. Sole proprietors are also allowed to establish certain retirement accounts that are tax-exempt until the funds are withdrawn, usually after age fifty-nine and a half.

Disadvantages of the Sole Proprietorship

The major disadvantage of the sole proprietorship is that the proprietor alone bears the burden of any losses or liabilities incurred by the business enterprise. In other words, the sole proprietor has unlimited liability, or legal responsibility, for all obligations that arise in doing business. Any lawsuit against the business or its employees can lead to

unlimited personal liability for the owner of a sole proprietorship. Creditors can go after the owner's personal assets to satisfy any business debts. This unlimited liability is a major factor to be considered in choosing a business form.

The sole proprietorship also has the disadvantage of lacking continuity on the death of the proprietor. When the owner dies, so does the business—it is automatically dissolved. Another disadvantage is that in raising capital, the proprietor is limited to his or her personal funds and any personal loans that he or she can obtain.

The personal liability of the owner of a sole proprietorship was at issue in the following case. The case involved the federal Cable Communications Act, which prohibits a commercial establishment from broadcasting television programs to its patrons without authorization. The court had to decide whether the owner of a sole proprietorship that installed a satellite television system was personally liable for violating this act by identifying a restaurant as a "residence" for billing purposes.



CASE 36.1

Garden City Boxing Club, Inc. v. Dominguez

United States District Court, Northern District of Illinois, Eastern Division, ___ F.Supp.2d ___ (2006).

BACKGROUND AND FACTS • Garden City Boxing Club, Inc. (GCB), which is based in San Jose, California, owned the exclusive right to broadcast several prizefights, via closed-circuit television, including a match between Oscar De La Hoya and Fernando Vargas on September 14, 2002. GCB sold the right to receive the broadcasts to bars and other commercial venues. The fee was \$20 multiplied by an establishment's maximum fire code occupancy. Antenas Enterprises in Chicago, Illinois, sells and installs satellite television systems under a contract with DISH Network. After installing a system, Antenas sends the buyer's address and other identifying information to DISH. In January 2002, Luis Garcia, an Antenas employee, identified a new customer as Jose Melendez at 220 Hawthorn Commons in Vernon Hills. The address was a restaurant—Mundelein Burrito—but Garcia designated the account as residential. Mundelein's patrons watched the De La Hoya–Vargas match on September 14, as well as three other fights on other dates, for which the restaurant paid only the residential rate to DISH and nothing to GCB. GCB filed a suit in a federal district court against Luis Dominguez, the sole proprietor of Antenas, to collect the fee.



IN THE LANGUAGE OF THE COURT

LEINENWEBER, J. [Judge]

* * * *

Section 605(a) [of the Cable Communications Act] states "[a]n authorized intermediary of a communication violates the Act when it divulges communication through an electronic channel to one other than the addressee." Mundelein Burrito was clearly a commercial establishment. The structure of the building, an exterior identification sign, and its location in a strip mall made this obvious. Mundelein Burrito paid only the residential fee for the four fights it broadcast to its patrons. It was not an authorized addressee of any of the four fights. By improperly listing Mundelein Burrito as a residence, Antenas Enterprises allowed

CASE CONTINUES ♦

CASE 36.1 CONTINUED ♦ the unauthorized broadcast of the [De La Hoya–Vargas fight], and three additional fights, to Mundelein Burrito. Antenas Enterprises is liable under [Section] 605 of the Act.

* * * *

The unauthorized broadcast of the four separate events deprived GCB of the full value of its business investment. * * * [Under the Cable Communications Act] an aggrieved party * * * may recover an award of damages “for each violation of [Section 605(a)] involved in the action in a sum of not less than \$1,000 or more than \$10,000, as the court considers just.” If the violation was willful and for purposes of commercial advantage or private financial gain, the court in its discretion may increase the award of damages—by an amount not more than \$100,000. The court must award attorneys’ fees to the prevailing party.

GCB argues that the Antenas Enterprises failure to properly list Mundelein Burrito resulted in four separate violations. According to the license fee charged for each of the four fights that were illegally broadcast by Mundelein Burrito, the proper amount would have been \$20.00 times the maximum fire code occupancy (46) or \$3,680.00. Instead, due to the improper identification of the account as residential, Mundelein Burrito paid only \$184.40 to broadcast the four events. GCB did not receive any of the \$184.40.

* * * [Considering] the willfulness of the defendant’s conduct and the deterrent value of the sanction imposed * * * twice the amount of actual damages is reasonable for this case. Therefore, Antenas Enterprises is liable to GCB for the sum of \$7,360.00. Pursuant to the Act, GCB is also entitled to reasonable attorneys’ fees.

* * * *

GCB argues Luis Dominguez is personally liable for Antenas Enterprises’ violation of [Section] 605 of the Act. The term “person” in the Act means an “individual, partnership, association, joint stock company, trust, corporation or governmental entity.”

Antenas Enterprises is a sole proprietorship, owned by Dominguez. *A sole proprietor is personally responsible for actions committed by his employees within the scope of their employment.* Accordingly, Dominguez is personally liable for the damages caused by the violation of [Section] 605 of the Act. [Emphasis added.]

DECISION AND REMEDY • *The court issued a summary judgment in GCB’s favor, holding that the plaintiff was entitled to the amount of Mundelein’s fee, for which Dominguez was personally liable, plus damages and attorneys’ fees.*

WHAT IF THE FACTS WERE DIFFERENT? • *If Mundelein had identified itself as a residence when ordering the satellite system, how might the result in this case have been different?*

THE GLOBAL DIMENSION • *Because the Internet has made it possible for sole proprietorships to do business worldwide without greatly increasing their costs, should they be considered, for some purposes, the equivalent of other business forms? Why or why not?*

SECTION 2 FRANCHISES

Instead of setting up a sole proprietorship to market their own products or services, many entrepreneurs opt to purchase a franchise. A **franchise** is an arrangement in which the owner of a trademark, a trade name, or a copyright licenses others to use the trademark, trade name, or copyright in the selling of goods or services. A **franchisee** (a purchaser of a franchise) is generally legally independent of the **franchisor** (the seller of the franchise). At the same time, the franchise is economically dependent on the franchisor’s integrated business system.

In other words, a franchisee can operate as an independent businessperson but still obtain the

advantages of a regional or national organization. Today, franchising companies and their franchisees account for a significant portion of all retail sales in this country. Well-known franchises include McDonald’s, 7-Eleven, and Holiday Inn. Franchising has also become a popular way for businesses to expand their operations internationally because franchisees can operate abroad without violating the legal restrictions that many nations impose on foreign ownership of businesses.

Types of Franchises

Many different kinds of businesses now sell franchises, and numerous types of franchises are available. Generally, though, franchises fall into one of three classifications: distributorships, chain-style business

operations, and manufacturing or processing-plant arrangements.

DISTRIBUTORSHIP In a *distributorship*, a manufacturer (the franchisor) licenses a dealer (the franchisee) to sell its product. Often, a distributorship covers an exclusive territory. An example is an automobile dealership or a beer distributorship, such as a distributorship for Anheuser-Busch products.

CHAIN-STYLE BUSINESS OPERATION In a *chain-style business operation*, a franchise operates under a franchisor's trade name and is identified as a member of a select group of dealers that engage in the franchisor's business. The franchisee is generally required to follow standardized or prescribed methods of operation. Often, the franchisor insists that the franchisee maintain certain standards of performance. In addition, the franchisee may be required to obtain materials and supplies exclusively from the franchisor. McDonald's and most other fast-food chains are examples of this type of franchise. Chain-style franchises are also common in service-related businesses, including real estate brokerage firms, such as Century 21, and tax-preparation services, such as H&R Block, Inc.

MANUFACTURING ARRANGEMENT In a *manufacturing, or processing-plant, arrangement*, the franchisor transmits to the franchisee the essential ingredients or formula to make a particular product. The franchisee then markets the product either at wholesale or at retail in accordance with the franchisor's standards. Examples of this type of franchise include Coca-Cola and other soft-drink bottling companies.

Laws Governing Franchising

Because a franchise relationship is primarily a contractual relationship, it is governed by contract law. If the franchise exists primarily for the sale of products manufactured by the franchisor, the law governing sales contracts as expressed in Article 2 of the Uniform Commercial Code applies (see Chapters 19 through 22). Additionally, the federal government and most states have enacted laws governing certain aspects of franchising. Generally, these laws are designed to protect prospective franchisees from dishonest franchisors and to prevent franchisors from terminating franchises without good cause.

FEDERAL REGULATION OF FRANCHISES The federal government regulates franchising through laws that apply to specific industries and through

the Franchise Rule, created by the Federal Trade Commission (FTC).

Industry-Specific Standards. Congress has enacted laws that protect franchisees in certain industries, such as automobile dealerships and service stations. These laws protect the franchisee from unreasonable demands and bad faith terminations of the franchise by the franchisor. If an automobile manufacturer-franchisor terminates a franchise because of a dealer-franchisee's failure to comply with unreasonable demands (for example, failure to attain an unrealistically high sales quota), the manufacturer may be liable for damages.² Similarly, federal law prescribes the conditions under which a franchisor of service stations can terminate the franchise.³ Federal antitrust laws (to be discussed in Chapter 47) also apply in certain circumstances to prohibit certain types of anticompetitive agreements.

The Franchise Rule. The FTC's Franchise Rule requires franchisors to disclose certain material facts that a prospective franchisee needs in order to make an informed decision concerning the purchase of a franchise.⁴ The rule was designed to enable potential franchisees to weigh the risks and benefits of an investment. The rule requires the franchisor to make numerous written disclosures to prospective franchisees, but franchisors can provide online disclosure documents as long as they met certain requirements. Prospective franchisees must be able to download or save all electronic disclosure documents.

Under the Franchise Rule, all representations made to a prospective franchisee must have a reasonable basis. If a franchisor provides projected earnings figures, the franchisor must indicate whether the figures are based on actual data or hypothetical examples. (The rule does not require franchisors to provide potential earnings figures, however, as discussed in the *Insight into Ethics* feature on the following page.) If a franchisor makes sales or earnings projections based on actual data for a specific franchise location, the franchisor must disclose the number and percentage of its existing franchises that have achieved this result.

Franchisors are required to explain termination, cancellation, and renewal provisions of the franchise contract to potential franchisees before the agreement is signed. In addition, a franchisor must

2. Automobile Dealers' Franchise Act of 1965, also known as the Automobile Dealers' Day in Court Act, 15 U.S.C. Sections 1221 *et seq.*

3. Petroleum Marketing Practices Act (PMPA) of 1979, 15 U.S.C. Sections 2801 *et seq.* See Extended Case 36.3 on pages 714 and 715.

4. 16 C.F.R. Section 436.1.



INSIGHT INTO ETHICS

Information on Potential Earnings Provided by Franchisors

Entrepreneurs who are thinking about investing in a franchise almost invariably ask, "How much will I make?"

Surprisingly, the law does not require franchisors to provide any estimate of, or actual data on, the earnings potential of a franchise. Franchisors can voluntarily choose to provide earnings data on their uniform disclosure documents but are not required to do so. If franchisors do make earnings claims, as mentioned in the text, they must indicate whether these figures are actual or hypothetical, follow specific rules, and have a reasonable basis for these claims. About 75 percent of franchisors choose not to provide information about earnings potential.

The failure of the FTC's Franchise Rule to require disclosure of earnings potential has led to many complaints from franchisees. After all, some franchisees invest their life savings in franchises that ultimately fail because of unrealistic earnings expectations. Moreover, the franchisee may be legally responsible to continue operating and paying the franchisor even when the business is not turning a profit.

For instance, Thomas Anderson asked the franchisor, Rocky Mountain Chocolate Factory, Inc. (RMCF), and five of its franchisees for earnings information before he entered into a franchise agreement, but he did not receive any data. When his chocolate franchise failed to become profitable, Anderson and his partner were ordered by a court to pay \$33,109 in past due royalties and interest to RMCF (plus court costs and expenses).^a

CRITICAL THINKING

INSIGHT INTO THE BUSINESS ENVIRONMENT

If the law required franchisors to provide estimates of potential earnings, would there be more or less growth in the number of franchises? Explain your answer.

a. *Rocky Mountain Chocolate Factory, Inc. v. SDMS, Inc.*, 2009 WL 579516 (D.Colo. 2009).

provide disclosures concerning any lawsuits that it has filed against franchisees and settlement agreements that it has entered into with them. Those who violate the Franchise Rule are subject to substantial civil penalties, and the FTC can sue on behalf of injured parties to recover damages.

STATE PROTECTION FOR FRANCHISEES State legislation varies but often is aimed at protecting franchisees from unfair practices and bad faith terminations by franchisors. Approximately fifteen states have laws similar to the federal rules that require franchisors to provide presale disclosures to prospective franchisees.⁵

Some state laws also require that a disclosure document (known as the Franchise Disclosure Document, or FDD) be registered or filed with a state official. State laws may also require that a franchisor submit advertising aimed at prospective franchisees to the state for approval. To protect franchisees, a state law might require the disclosure of information such as

the actual costs of operation, recurring expenses, and profits earned, along with facts substantiating these figures. State deceptive trade practices acts (see Chapter 45) may also apply and prohibit certain types of actions on the part of franchisors. To protect franchisees against arbitrary or bad faith terminations, state law may prohibit termination without "good cause" or require that certain procedures be followed in terminating a franchising relationship.

CASE IN POINT FMS, Inc., entered into a franchise agreement with Samsung Construction Equipment North America to become an authorized dealership for the sale of Samsung-brand equipment. Volvo Construction Equipment North America, Inc., purchased Samsung's business and eventually modified and rebranded the construction equipment so that it could be sold under its own name. When Volvo canceled FMS's franchise agreement, FMS filed a lawsuit alleging that Volvo, among other things, had violated Maine's franchise law, which prohibits termination of a franchise without "good cause." A federal appellate court, however, found that because Volvo was no longer manufacturing the Samsung-brand equipment, it did have good cause to terminate FMS's franchise. Although the statute would have prevented Volvo from terminating the FMS

5. These states include California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.

franchise as to the Samsung-brand equipment, the statute did not apply to the rebranded equipment.⁶

The Franchise Contract

The franchise relationship is defined by a contract between the franchisor and the franchisee. The franchise contract specifies the terms and conditions of the franchise and spells out the rights and duties of the franchisor and the franchisee. If either party fails to perform its contractual duties, that party may be subject to a lawsuit for breach of contract. Furthermore, if a franchisee is induced to enter into a franchise contract by the franchisor's fraudulent misrepresentation, the franchisor may be liable for damages. Generally, statutes and the case law governing franchising tend to emphasize the importance of good faith and fair dealing in franchise relationships.

Because each type of franchise relationship has its own characteristics, it is difficult to describe the broad range of details a franchising contract may include. We look next at some of the major issues that typically are addressed in a franchise contract.

PAYMENT FOR THE FRANCHISE The franchisee ordinarily pays an initial fee or lump-sum price for the franchise license (the privilege of being granted a franchise). This fee is separate from the various products that the franchisee purchases from or through the franchisor. In some industries, the franchisor relies heavily on the initial sale of the franchise for realizing a profit. In other industries, the continued dealing between the parties brings profit to both. In most situations, the franchisor receives a stated percentage of the annual (or monthly) sales or annual volume of business done by the franchisee. The franchise agreement may also require the franchisee to pay a percentage of the franchisor's advertising costs and certain administrative expenses.

BUSINESS PREMISES The franchise agreement may specify whether the premises for the business must be leased or purchased outright. Sometimes, a building must be constructed to meet the terms of the agreement. Certainly, the agreement will specify whether the franchisor or the franchisee is responsible for supplying equipment and furnishings for the premises.

LOCATION OF THE FRANCHISE Typically, the franchisor determines the territory to be served. Some franchise contracts give the franchisee exclusive rights, or "territorial rights," to a certain geographic area. Other franchise contracts, while defining the territory allotted to a particular franchise, either specifically state that the franchise is nonexclusive or are silent on the issue of territorial rights.

Many franchise cases involve disputes over territorial rights, and the implied covenant of good faith and fair dealing often comes into play in this area of franchising. If the franchise contract does not grant the franchisee exclusive territorial rights and the franchisor allows a competing franchise to be established nearby, the franchisee may suffer a significant loss in profits. In this situation, a court may hold that the franchisor's actions breached an implied covenant of good faith and fair dealing.

BUSINESS ORGANIZATION As part of the franchise agreement, the franchisor may require that the business use a particular organizational form and capital structure. The franchise agreement may also set out standards of operation in such aspects of the business as sales quotas, quality, and record keeping. Additionally, a franchisor may retain stringent control over the training of personnel involved in the operation and over administrative aspects of the business.

QUALITY CONTROL The day-to-day operation of the franchise business normally is left up to the franchisee. Nonetheless, the franchise agreement may provide for some degree of supervision and control by the franchisor so that it can protect the franchise's name and reputation. When the franchise prepares a product, such as food, or provides a service, such as motel accommodations, the contract often states that the franchisor will establish certain standards for the facility. Typically, the contract will state that the franchisor is permitted to make periodic inspections to ensure that the standards are being maintained.

As a general rule, the validity of a provision permitting the franchisor to establish and enforce certain quality standards is unquestioned. Because the franchisor has a legitimate interest in maintaining the quality of the product or service to protect its name and reputation, it can exercise greater control in this area than would otherwise be tolerated. If a franchisor exercises too much control over the operations of its franchisees, however, the franchisor risks potential liability under agency law for the tortious acts of the franchisees' employees (see Chapter 33).

6. *FMS, Inc. v. Volvo Construction Equipment North America, Inc.*, 557 F.3d 758 (7th Cir. 2009).

PRICING ARRANGEMENTS Franchises provide the franchisor with an outlet for the firm's goods and services. Depending on the nature of the business, the franchisor may require the franchisee to purchase certain supplies from the franchisor at an established price.⁷ A franchisor cannot, however, set the prices at which the franchisee will resell the goods because such price setting may be a violation of state or federal antitrust laws, or both. A franchisor can suggest retail prices but cannot mandate them.

SECTION 3

FRANCHISE TERMINATION

The duration of the franchise is a matter to be determined between the parties. Generally, a franchise relationship starts with a short trial period, such

7. Although a franchisor can require franchisees to purchase supplies from it, requiring a franchisee to purchase exclusively from the franchisor may violate federal antitrust laws (see Chapter 47).

as a year, so that the franchisee and the franchisor can determine whether they want to stay in business with one another. Usually, the franchise agreement specifies that termination must be "for cause," such as the death or disability of the franchisee, insolvency of the franchisee, breach of the franchise agreement, or failure to meet specified sales quotas. Most franchise contracts provide that notice of termination must be given. If no set time for termination is specified, then a reasonable time, with notice, is implied. A franchisee must be given reasonable time to wind up the business—that is, to do the accounting and return the copyright or trademark or any other property of the franchisor.

A franchise agreement may grant the franchisee the opportunity to cure an ordinary, curable breach within a certain period of time after notice to enable the franchisee to postpone, or even avoid, the termination of the contract. Could a franchisee's conduct so seriously undermine the basis of the agreement that the franchisor could cancel the contract despite a notice-and-cure provision? That was the issue in the following case.



CASE 36.2

LJL Transportation, Inc. v. Pilot Air Freight Corp.

Supreme Court of Pennsylvania, 599 Pa. 546, 962 A.2d 639 (2009).
www.courts.state.pa.us/T/SupremeCourt

BACKGROUND AND FACTS • Pilot Air Freight Corporation moves freight through a network of company-owned and company-franchised locations at airports and other sites. Franchisees included LJL Transportation, Inc., which is owned by Louis Pektor and Leo Decker. The franchise agreement required LJL to assign all shipments to the Pilot network. The agreement also provided that "Pilot shall allow Franchisee an opportunity to cure a default within ninety (90) days of receipt of written notice." After eight years as a Pilot franchisee, LJL began to divert shipments to Northeast Transportation, a competing service owned by Pektor and Decker. On learning of the diversions, Pilot terminated the franchise agreement. LJL filed a suit in a Pennsylvania state court against Pilot, alleging breach of contract and asserting a right to cure. The court issued a summary judgment in Pilot's favor, and a state intermediate appellate court affirmed. LJL appealed.



IN THE LANGUAGE OF THE COURT

Justice **TODD**.

* * * *

* * * There is no Pennsylvania case law directly governing the resolution of the particular question presented in this appeal * * *. Courts from other jurisdictions appear to be in accord that * * * a termination clause affording the right to notice and cure is * * * a cumulative remedy which does not bar the non-breaching party from exercising

- a. In the "Conducting Business with the Court" section, click on "Supreme Court Opinions." On that page, in the "Caption" box, type "LJL"; in the "Month" pull-down menu, select "January"; in the "Year" pull-down menu, choose "2009"; and click on "Search." In the result, click on the link to access the opinion. The Unified Judicial System of Pennsylvania maintains this Web site.

CASE 36.2 CONTINUED ♦ other remedies available to it in the event of a breach by the other party going directly to the heart of the contract, and destroying the fundamental trust upon which the contractual relationship is built.

* * *

* * * [This] view [is] consistent with the law * * * regarding the effect of material breaches, and likewise consistent with the policy * * * requiring good faith and honesty in the performance and enforcement of contractual relations.

* * *

* * * *Self-dealing is the antithesis [exact opposite] of that [policy] and it violates the relationship of trust necessarily underlying such agreements.* [Emphasis added.]

*The franchisee's breach of its implied duty of honesty and fidelity [goes] to the heart of the contract. Merely requiring the franchisee to retroactively undo its wrongdoing * * * would not be an adequate remedy.* [Emphasis added.]

* * *

* * * Consequently, we have no difficulty in concluding that when there is a breach of contract going directly to the essence of the contract, which is so exceedingly grave as to irreparably damage the trust between the contracting parties, the non-breaching party may terminate the contract without notice * * *. Requiring such notice before termination under such circumstances would be a useless gesture, as such a breach may not reasonably be cured. Such a breach is so fundamentally destructive, it understandably and inevitably causes the trust which is the bedrock foundation and veritable lifeblood of the parties' contractual relationship to essentially evaporate. We find our law does not require a non-breaching party to prolong a contractual relationship under such circumstances.

DECISION AND REMEDY • *The Pennsylvania Supreme Court affirmed the lower court's judgment. A franchise agreement may be terminated immediately when there is a material breach of the contract so serious it goes directly to the heart and essence of the contract, rendering the breach incurable.*

THE ETHICAL DIMENSION • *From an ethical perspective, if LJI had been allowed to invoke the right-to-cure provision, could it have undone its wrongdoing so that the franchise relationship could have continued? Why or why not?*

WHAT IF THE FACTS WERE DIFFERENT? • *Suppose that Pilot had terminated its franchise agreement simply because it no longer wished to be bound. Would refusing to allow LJI to invoke the right-to-cure provision in that circumstance have been valid?*

Wrongful Termination

Because a franchisor's termination of a franchise often has adverse consequences for the franchisee, much franchise litigation involves claims of wrongful termination. Generally, the termination provisions of contracts are more favorable to the franchisor than to the franchisee. This means that the franchisee, who normally invests a substantial amount of time and financial resources in making the franchise operation successful, may receive little or nothing for the business on termination. The franchisor owns the trademark and hence the business. It is in this area that statutory and case law become important. The federal and state laws discussed earlier attempt, among other things, to protect franchisees from the

arbitrary or unfair termination of their franchises by the franchisors.

In the following case, a group of service-station franchisees claimed that their franchisor had violated the Petroleum Marketing Practices Act (PMPA) of 1979, which limits the circumstances in which petroleum franchisors may terminate a franchise. The franchisees contended that changes in the rental provisions of the franchise contract had effectively increased their fuel costs, thereby "constructively" (in effect) terminating the franchises. The franchisees, however, had continued to operate their service stations. Under the PMPA, must a franchisee abandon its franchise in order to recover for constructive termination? That was the issue facing the United States Supreme Court.



* EXTENDED CASE 36.3 *

Mac's Shell Service, Inc. v. Shell Oil Products Co.

Supreme Court of the United States, ___ U.S. ___, 130 S.Ct. 1251, 176 L.Ed.2d 36 (2010).
www.supremecourt.gov^a

IN THE LANGUAGE OF THE COURT



Justice *ALITO* delivered the opinion of the Court.
 * * *

This litigation involves a dispute between Shell Oil Company (Shell), a petroleum franchisor, and several Shell franchisees in Massachusetts. Pursuant to their franchise agreements with Shell, each franchisee was required to pay Shell monthly rent for use of the service-station premises. For many years, Shell offered the franchisees a rent subsidy that reduced the monthly rent by a set amount for every gallon of motor fuel a franchisee sold above a specified threshold. Shell renewed the subsidy annually through notices that “explicitly provided for cancellation [of the rent subsidy] with thirty days’ notice.” Nonetheless, Shell representatives made various oral representations to the franchisees “that the subsidy or something like it would always exist.”

In 1998, Shell joined with two other oil companies to create Motiva Enterprises LLC (Motiva), a joint venture that combined the companies’ petroleum-marketing operations in the eastern United States. Shell assigned to Motiva its rights and obligations under the relevant franchise agreements. * * * Effective January 1, 2000, Motiva ended the volume-based rent subsidy, thus increasing the franchisees’ rent.

In July 2001, sixty-three Shell franchisees (hereinafter dealers) filed suit against Shell and Motiva in Federal District Court. Their complaint alleged that Motiva’s

discontinuation of the rent subsidy constituted a breach of contract under state law. Additionally, the dealers asserted [a claim] under the PMPA [Petroleum Marketing Practices Act]. * * * They maintained that Shell and Motiva, by eliminating the rent subsidy, had “constructively terminated” their franchises in violation of the Act.

After a two-week trial involving eight of the dealers, the jury found against Shell and Motiva on all claims. Both before and after the jury’s verdict, Shell and Motiva moved for judgment as a matter of law on the dealers’ [PMPA claim]. They argued that they could not be found liable for constructive termination under the Act because none of the dealers had abandoned their franchises in response to Motiva’s elimination of the rent subsidy—something Shell and Motiva said was a necessary element of any constructive termination claim.

* * * The District Court denied [the motion], and Shell and Motiva appealed. [The U.S. Court of Appeals for the First Circuit affirmed the district court’s judgment, and Shell and Motiva appealed to the United States Supreme Court.]

* * *

The * * * question we are asked to decide is whether a service-station franchisee may recover for constructive termination under the PMPA when the franchisor’s allegedly wrongful conduct did not force the franchisee to abandon its franchise. *For the reasons that follow, we conclude that a necessary element of any constructive termination claim under the Act is that the franchisor’s conduct forced an end to the franchisee’s use of*

the franchisor’s trademark, purchase of the franchisor’s fuel, or occupation of the franchisor’s service station. [Emphasis added.]

When given its ordinary meaning, the text of the PMPA prohibits only that franchisor conduct that has the effect of ending a franchise. As relevant here, the Act provides that “no franchisor * * * may * * * terminate any franchise,” except for an enumerated reason and after providing written notice.

The word “terminate” ordinarily means “put an end to.” * * * The object of the verb “terminate” is the noun “franchise,” a term the Act defines as “any contract” for the provision of one (or more) of the three elements of a typical petroleum franchise. Thus, when given its ordinary meaning, the Act is violated only if an agreement for the use of a trademark, purchase of motor fuel, or lease of a premises is “put [to] an end” * * *. Conduct that does not force an end to the franchise, in contrast, is not prohibited by the Act’s plain terms.

* * *

Requiring franchisees to abandon their franchises before claiming constructive termination is also consistent with the general understanding of the doctrine of constructive termination. As applied in analogous legal contexts—both now and at the time Congress enacted the PMPA—a plaintiff must actually sever a particular legal relationship in order to maintain a claim for constructive termination. For example, courts have long recognized a theory of constructive discharge in the field of employment law. Similarly, landlord-tenant law has long recognized the

a. Select “Opinions” under “Supreme Court Documents” in the left column. On the page that opens, under “Current Term,” select “Latest Slip Opinions.” In the list of cases that appears, scroll down to “30” and click on the case title to access the opinion. The United States Supreme Court maintains this Web site.

EXTENDED CASE 36.3 CONTINUED ▼

concept of constructive eviction. The general rule under that doctrine is that a tenant must actually move out in order to claim constructive eviction. [Emphasis added.]

As generally understood in these and other contexts, a termination is deemed "constructive" because it is the plaintiff, rather than the defendant, who formally puts an end to the particular legal relationship—not because there is no end to the relationship at all. There is no reason why a different understanding should apply to constructive

termination claims under the PMPA. At the time when it enacted the statute, Congress presumably was aware of how courts applied the doctrine of constructive termination in these analogous legal contexts. And in the absence of any contrary evidence, we think it reasonable to interpret the Act in a way that is consistent with this well-established body of law.

* * * *

We therefore hold that a necessary element of any constructive termination claim under the PMPA is that the complained-of conduct forced an end to the franchisee's use of the franchisor's trademark,

purchase of the franchisor's fuel, or occupation of the franchisor's service station. Because none of the dealers in this litigation abandoned any element of their franchise operations in response to Motiva's elimination of the rent subsidy, they cannot maintain a constructive termination claim on the basis of that conduct.

* * * *

The judgment of the Court of Appeals is reversed * * *. The cases are remanded for further proceedings consistent with this opinion.

It is so ordered.

**QUESTIONS**

1. The PMPA regulates only the circumstances in which service-station franchisors may terminate a franchise or decline to renew a franchise relationship. Are there any reasons why Congress might have limited the scope of the PMPA to just these two aspects of franchising? Explain.
2. Suppose that some of the service-station franchisees, on the expiration of their contracts with Shell, signed a renewal agreement with Motiva, even though the franchisees believed that the rental terms of the new agreement were unacceptable. Given the Court's reasoning on the issue of constructive termination, would the franchisees have been likely to succeed in a suit against the franchisor for "constructive nonrenewal" of the franchise agreement? Why or why not?

The Importance of Good Faith and Fair Dealing

Generally, both statutory law and case law emphasize the importance of good faith and fair dealing in terminating a franchise relationship. In determining whether a franchisor has acted in good faith when terminating a franchise agreement, the courts usually try to balance the rights of both parties. If a court perceives that a franchisor has arbitrarily or unfairly terminated a franchise, the franchisee will be provided with a remedy for wrongful termination. If a franchisor's decision to terminate a franchise was made in the normal course of the franchisor's business operations, however, and reasonable notice of termination was given to the franchisee, in most instances a court will not consider the termination wrongful.

CASE IN POINT Chapin Miller acquired Chic Miller's Chevrolet, a General Motors Corporation (GM) dealership. Chic Miller's entered into lending

agreements, commonly known as floor plan financing, to enable it to buy new vehicles from GM. At first, the dealership had floor plan financing through GM, but then it switched to Chase Manhattan Bank. In 2002, Chase declined to provide further financing, and Chic Miller's was unable to obtain a loan from any other lender, including GM. Under the franchise's "Dealer Sales and Service Agreement," GM could terminate a dealership for "Failure of Dealer to maintain the line of credit." In March 2003, GM terminated Chic Miller's franchise. Chic Miller's claimed that GM had failed to act in good faith in terminating the franchise, but the court held in GM's favor. GM had good cause to terminate the dealership because Chic Miller's failed to maintain floor plan financing, which was a material requirement under the franchise agreement.⁸

8. *Chic Miller's Chevrolet, Inc. v. General Motors, Inc.*, 352 F.Supp.2d 251 (D.Conn. 2005).



REVIEWING

Sole Proprietorships and Franchises

Carlos Del Rey decided to open a Mexican fast-food restaurant and signed a franchise contract with a national chain called La Grande Enchilada. The contract required the franchisee to strictly follow the franchisor's operating manual and stated that failure to do so would be grounds for terminating the franchise contract. The manual set forth detailed operating procedures and safety standards, and provided that a La Grande Enchilada representative would inspect the restaurant monthly to ensure compliance. Nine months after Del Rey began operating his restaurant, a spark from the grill ignited an oily towel in the kitchen. No one was injured, but by the time firefighters were able to put out the fire, the kitchen had sustained extensive damage. The cook told the fire department that the towel was "about two feet from the grill" when it caught fire. This was in compliance with the franchisor's manual that required towels be placed at least one foot from the grills. Nevertheless, the next day La Grande Enchilada notified Del Rey that his franchise would terminate in thirty days for failure to follow the prescribed safety procedures. Using the information presented in the chapter, answer the following questions.

1. What type of franchise was Del Rey's La Grande Enchilada restaurant?
2. If Del Rey operates the restaurant as a sole proprietorship, then who bears the loss for the damaged kitchen? Explain.
3. Assume that Del Rey files a lawsuit against La Grande Enchilada, claiming that his franchise was wrongfully terminated. What is the main factor that a court would consider in determining whether the franchise was wrongfully terminated?
4. Would a court be likely to rule that La Grande Enchilada had good cause to terminate Del Rey's franchise in this situation? Why or why not?

DEBATE THIS: All franchisors should be required by law to provide a comprehensive estimate of the profitability of a prospective franchise based on the experiences of their existing franchisees.



TERMS AND CONCEPTS

entrepreneur 706

franchise 708
franchisee 708
franchisor 708

sole proprietorship 706



QUESTIONS AND CASE PROBLEMS

36-1. Franchising Maria, Pablo, and Vicky are recent college graduates who would like to go into business for themselves. They are considering purchasing a franchise. If they enter into a franchising arrangement, they would have the support of a large company that could answer any questions they might have. Also, a firm that has been in business for many years would be experienced in dealing with some of the problems that novice businesspersons might encounter. These and other attributes of franchises can lessen some of the risks of the marketplace. What other aspects of franchising—positive and negative—should

Maria, Pablo, and Vicky consider before committing themselves to a particular franchise?

36-2. QUESTION WITH SAMPLE ANSWER: Control of a Franchise.



National Foods, Inc., sells franchises to its fast-food restaurants, known as Chicky-D's. Under the franchise agreement, franchisees agree to hire and train employees strictly according to Chicky-D's standards. Chicky-D's regional supervisors are required to approve all job candidates before they are hired and all general policies affecting those employees. Chicky-D's reserves the right to terminate a franchise for

violating the franchisor's rules. In practice, however, Chicky-D's regional supervisors routinely approve new employees and individual franchisees' policies. After several incidents of racist comments and conduct by Tim, a recently hired assistant manager at a Chicky-D's, Sharon, a counterperson at the restaurant, resigns. Sharon files a suit in a federal district court against National. National files a motion for summary judgment, arguing that it is not liable for harassment by franchise employees. Will the court grant National's motion? Why or why not?

- For a sample answer to Question 36-2, go to Appendix I at the end of this text.

36-3. The Franchise Contract Otmar has secured a high-quality ice cream franchise. The franchise agreement calls for Otmar to sell the ice cream only at a specific location; to buy all the ice cream from the franchisor; to order and sell all the flavors produced by the franchisor; and to refrain from selling any ice cream stored for more than two weeks after delivery by the franchisor, as the quality of the ice cream declines after that period of time. After two months of operation, Otmar believes that he can increase his profits by moving the store to another part of the city. He refuses to order even a limited quantity of the "fruit delight" flavor because of its higher cost, and he has sold ice cream that has been stored longer than two weeks without customer complaint. Otmar maintains that the franchisor has no right to restrict him in these practices. Discuss his claims.

36-4. Franchise Termination In the automobile industry, luxury-car customers are considered the most demanding segment of the market with respect to customer service. Jaguar Cars, a division of Ford Motor Co. until 2008, was the exclusive U.S. distributor of Jaguar luxury cars. Jaguar Cars distributes its products through franchised dealers. In April 1999, Dave Ostrem Imports, Inc., an authorized Jaguar dealer in Des Moines, Iowa, contracted to sell its dealership to Midwest Automotive III, LLC. A Jaguar franchise generally cannot be sold without Jaguar Cars' permission. Jaguar Cars asked Midwest Auto to submit three years of customer satisfaction index (CSI) data for all franchises with which its owners had been associated. (CSI data are intended to measure how well dealers treat their customers and satisfy their customers' needs. Jaguar Cars requires above-average CSI ratings for its dealers.) Most of Midwest Auto's scores fell below the national average. Jaguar Cars rejected Midwest Auto's application and sought to terminate the franchise, claiming that a transfer of the dealership would be "substantially detrimental" to the distribution of Jaguar vehicles in the community. Was Jaguar Cars' attempt to terminate this franchise reasonable? Why or why not? [*Midwest Automotive III, LLC v. Iowa Department of Transportation*, 646 N.W.2d 417 (Iowa 2002)]

36-5. The Franchise Contract On August 23, 1995, Climaco Guzman entered into a commercial janitorial services franchise agreement with Jan-Pro Cleaning Systems,

Inc., in Rhode Island for a franchise fee of \$3,285. In the agreement, Jan-Pro promised to furnish Guzman with "one (1) or more customer account(s) . . . amounting to \$8,000.00 gross volume per year. . . . No portion of the franchise fee is refundable except and to the extent that the Franchisor, within 120 business days following the date of execution of the Franchise Agreement, fails to provide accounts." By February 19, Guzman had not received any accounts and demanded a full refund. Jan-Pro then promised "two accounts grossing \$12,000 per year in income." Despite its assurances, Jan-Pro did not have the ability to furnish accounts that met the requirements. In September, Guzman filed a suit in a Rhode Island state court against Jan-Pro, alleging, in part, fraudulent misrepresentation. Should the court rule in Guzman's favor? Why or why not? [*Guzman v. Jan-Pro Cleaning Systems, Inc.*, 839 A.2d 504 (R.I. 2003)]

36-6. Sole Proprietorship James Ferguson operates Jim's 11#E Auto Sales in Jonesborough, Tennessee, as a sole proprietorship. In 1999, Consumers Insurance Co. issued a policy to "Jim Ferguson, Jim's 11#E Auto Sales" covering "Owned 'Autos' Only." *Auto* was defined to include "a land motor vehicle," which was not further explained in the policy. Coverage extended to damage caused by the owner or driver of an underinsured motor vehicle. In 2000, Ferguson bought and titled in his own name a 1976 Harley-Davidson motorcycle, intending to repair and sell the cycle through his dealership. In October 2001, while riding the motorcycle, Ferguson was struck by an auto driven by John Jenkins. Ferguson filed a suit in a Tennessee state court against Jenkins, who was underinsured with respect to Ferguson's medical bills, and Consumers. The insurer argued, among other things, that because the motorcycle was bought and titled in Ferguson's own name, and he was riding it at the time of the accident, it was his personal vehicle and thus was not covered under the dealership's policy. What is the relationship between a sole proprietor and a sole proprietorship? How might this status affect the court's decision in this case? [*Ferguson v. Jenkins*, 204 S.W.3d 779 (Tenn.App. 2006)]

36-7. CASE PROBLEM WITH SAMPLE ANSWER: Franchise Termination.



Walid Elkhatib, a Palestinian Arab, emigrated to the United States in 1971 and became a U.S. citizen. Eight years later, Elkhatib bought a Dunkin' Donuts, Inc., franchise in Bellwood, Illinois.

Dunkin' Donuts began offering breakfast sandwiches with bacon, ham, or sausage through its franchises in 1984, but Elkhatib refused to sell these items at his store on the ground that his religion forbade the handling of pork. In 1995, Elkhatib opened a second franchise in Berkeley, Illinois, at which he also refused to sell pork products. The next year, at both locations, Elkhatib began selling meatless sandwiches. In 1998, Elkhatib opened a third franchise in Westchester, Illinois. When he proposed to relocate this franchise, Dunkin' Donuts refused to approve the new location and added that it

would not renew any of his franchise agreements because he did not carry the full sandwich line. Elkhatib filed a suit in a federal district court against Dunkin' Donuts and others. The defendants filed a motion for summary judgment. Did Dunkin' Donuts act in good faith in its relationship with Elkhatib? Explain. [Elkhatib v. Dunkin' Donuts, Inc., 493 F.3d 827 (7th Cir. 2007)]

- To view a sample answer for Problem 36–7, go to this book's Web site at www.cengage.com/blaw/clarkson, select "Chapter 36," and click on "Case Problem with Sample Answer."

36–8. Sole Proprietorship Julie Anne Gaskill is an oral and maxillofacial surgeon in Bowling Green, Kentucky. Her medical practice is a sole proprietorship that consists of Gaskill as the sole surgeon and an office staff. She sees every patient, exercises all professional judgment and skill, and manages the business. When Gaskill and her spouse, John Robbins, initiated divorce proceedings in a Kentucky state court, her accountant estimated the value of the practice at \$221,610, excluding goodwill. Robbins's accountant estimated the value at \$669,075, including goodwill. (Goodwill is the ability or reputation of a business to draw customers, get them to return, and contribute to future profitability.) How can a sole proprietor's reputation, skill, and relationships with customers be valued? Could these qualities be divided into "personal" and "enterprise" goodwill, with some goodwill associated with the business and some solely due to the personal qualities of the proprietor? If so, what might comprise each type? Is this an effective method for valuing Gaskill's practice? Discuss. [Gaskill v. Robbins, 282 S.W.3d 306 (Ky. 2009)]

36–9. Franchise Disclosure Peaberry Coffee, Inc., owned and operated about twenty company stores in the Denver area. The company began a franchise program and prepared a disclosure document as required by the Federal Trade Commission (FTC). Peaberry sold ten franchises, and each franchisee received a disclosure document. Later, when the franchises did not do well, the franchisees sued Peaberry, claiming that its FTC disclosure document had been fraudulent. Specifically, the franchisees claimed that Peaberry had not disclosed that most of the company stores were unprofitable and that its parent company had suffered significant financial losses over the years. In addition, the trial court found that an article in the *Denver Business Journal*—in which an

executive had said that Peaberry was profitable—was fraudulent. This article had been included in the franchisees' information packets. The district court dismissed the franchisees' complaint, noting that the FTC disclosure document had contained an exculpatory clause (see Chapter 13). This clause said that the buyers should not rely on any material that was not in the franchise contract itself. The franchisees appealed. Can a franchisor disclaim the relevance of the information it provides to franchisees? Why or why not? [Colorado Coffee Bean, LLC v. Peaberry Coffee, Inc., ___ P.3d ___ (Colo.App. 2010)]

36–10. A QUESTION OF ETHICS: Sole Proprietorship.



In August 2004, Ralph Vilardo contacted Travel Center, Inc., in Cincinnati, Ohio, to buy a trip to Florida in December for his family to celebrate his fiftieth wedding anniversary. Vilardo paid \$6,900 to David Sheets, the sole proprietor of Travel Center. Vilardo also paid \$195 to Sheets for a separate trip to Florida in February 2005. Sheets assured Vilardo that everything was set, but in fact no arrangements were made. Later, two unauthorized charges for travel services totaling \$1,182.35 appeared on Vilardo's credit-card statement. Vilardo filed a suit in an Ohio state court against Sheets and his business, alleging, among other things, fraud and violations of the state consumer protection law. Vilardo served Sheets and Travel Center with copies of the complaint, the summons, a request for admissions, and other documents filed with the court, including a motion for summary judgment. Each of these filings asked for a response within a certain time period. Sheets responded once on his own behalf with a denial of all of Vilardo's claims. Travel Center did not respond. [Vilardo v. Sheets, ___ Ohio App.3d ___ (2006)]

- Almost four months after Vilardo filed his complaint, Sheets decided that he was unable to adequately represent himself and retained an attorney, who asked the court for more time. Should the court grant this request? Why or why not? Ultimately, what should the court rule?
- Sheets admitted that Travel Center, Inc., was a sole proprietorship. He also argued that liability might be imposed on his business but not on himself. How would you rule with respect to this argument? Why? Would there be anything unethical about allowing Sheets to avoid liability on this basis? Explain.



LEGAL RESEARCH EXERCISES ON THE WEB

Go to this text's Web site at www.cengage.com/blaw/clarkson, select "Chapter 36," and click on "Practical Internet Exercises." There you will find the following Internet research exercises that you can perform to learn more about the topics covered in this chapter.

Practical Internet Exercise 36–1: Legal Perspective

Starting a Business

Practical Internet Exercise 36–2: Management Perspective

Franchises

CHAPTER 37



Partnerships and Limited Liability Partnerships



Traditionally, the two most common forms of business organization selected by two or more persons entering into business together have been the partnership and the corporation. A *partnership* arises from an agreement, express or implied, between two or more persons to carry on a business for a profit. Partners are co-

owners of the business and have joint control over its operation and the right to share in its profits. In this chapter, we examine several forms of partnership. (Corporations will be discussed in Chapters 39 through 41.)

We begin the chapter with an examination of traditional partnerships, or *general partnerships*, and the rights

and duties of partners in this business entity.

We then examine some special forms of partnerships known as *limited partnerships* and *limited liability partnerships*, which receive a different treatment under the law.

SECTION 1 BASIC PARTNERSHIP CONCEPTS

Partnerships are governed both by common law concepts (in particular, those relating to agency) and by statutory law. As in so many other areas of business law, the National Conference of Commissioners on Uniform State Laws has drafted uniform laws for partnerships, and these have been widely adopted by the states.

Agency Concepts and Partnership Law

When two or more persons agree to do business as partners, they enter into a special relationship with one another. To an extent, their relationship is similar to an agency relationship because each partner is deemed to be the agent of the other partners and of the partnership. The agency concepts that were discussed in Chapters 32 and 33 thus apply—specifically, the imputation of knowledge of, and responsibility for, acts carried out within the scope of the partnership relationship. In their relationships with one another, partners, like agents, are bound by fiduciary ties.

In one important way, however, partnership law is distinct from agency law. In a partnership, two or

more persons agree to commit some or all of their funds or other assets, labor, and skills to a business with the understanding that profits and losses will be shared. Thus, each partner has an ownership interest in the firm. In a nonpartnership agency relationship, the agent usually does not have an ownership interest in the business, nor is he or she obligated to bear a portion of ordinary business losses.

The Uniform Partnership Act

The Uniform Partnership Act (UPA) governs the operation of partnerships *in the absence of express agreement* and has done much to reduce controversies in the law relating to partnerships. Except for Louisiana, all of the states, as well as the District of Columbia, have adopted the UPA. A majority of the states have enacted the most recent version of the UPA to provide limited liability for partners in a limited liability partnership.¹ Excerpts from the latest version of the UPA are presented in Appendix E.

1. At the time this book went to press, more than two-thirds of the states, as well as the District of Columbia, Puerto Rico, and the U.S. Virgin Islands, had adopted the UPA with the 1997 amendments.

Definition of a Partnership

Parties sometimes find themselves in conflict over whether their business enterprise is a legal partnership. The UPA defines a **partnership** as “an association of two or more persons to carry on as co-owners a business for profit” [UPA 101(6)]. Note that the UPA’s definition of *person* includes corporations, so a corporation can be a partner in a partnership [UPA 101(10)]. The *intent* to associate is a key element of a partnership, and one cannot join a partnership unless all other partners consent [UPA 401(i)].

When Does a Partnership Exist?

In resolving disputes over whether a partnership exists, courts usually look for the following three essential elements, which are implicit in the UPA’s definition of a general partnership:

1. A sharing of profits or losses.
2. A joint ownership of the business.
3. An equal right to be involved in the management of the business.

If the evidence in a particular case is insufficient to establish all three factors, the UPA provides a set of guidelines to be used. For example, the sharing of profits and losses from a business creates a presumption that a partnership exists. No presumption is made, however, if the profits were received as payment of any of the following [UPA 202(c)(3)]:

1. A debt by installments or interest on a loan.
2. Wages of an employee or for the services of an independent contractor.
3. Rent to a landlord.
4. An annuity to a surviving spouse or representative of a deceased partner.
5. A sale of the **goodwill** (the valuable reputation of a business viewed as an intangible asset) of a business or property.

To illustrate: A debtor owes a creditor \$5,000 on an unsecured debt. To repay the debt, the debtor agrees to pay (and the creditor, to accept) 10 percent of the debtor’s monthly business profits until the loan with interest has been paid. Although the creditor is sharing profits from the business, the debtor and creditor are not presumed to be partners.

Joint Property Ownership and Partnership Status

Joint ownership of property does not in and of itself create a partnership. In fact, the sharing of

gross returns and even profits from such ownership “does not by itself establish a partnership” [UPA 202(c)(1) and (2)].² Suppose that MacPherson and Bunker jointly own a piece of farmland and lease it to a farmer for a share of the profits from the farming operation in lieu of set rental payments. This arrangement normally would not make MacPherson, Bunker, and the farmer partners.

Note, though, that while the sharing of profits from ownership of property does not prove the existence of a partnership, sharing *both profits and losses* usually does. For example, two sisters, Zoe and Cienna, buy a restaurant together, open a joint bank account from which they pay for supplies and expenses, and share the proceeds (and losses) that the restaurant generates. Zoe manages the restaurant and Cienna handles the bookkeeping. After eight years, Cienna stops keeping the books and does no other work for the restaurant. Zoe claims that she and Cienna did not establish a partnership. In this situation, a court would find that a partnership existed because the sisters shared management responsibilities, had a joint account, and shared the profits and losses of the restaurant equally.

Entity versus Aggregate

At common law, a partnership was treated only as an aggregate of individuals and never as a separate legal entity. Thus, at common law a lawsuit could never be brought by or against the firm in its own name; each individual partner had to sue or be sued.

Today, in contrast, a majority of the states follow the UPA and treat a partnership as an entity for most purposes. For example, a partnership usually can sue or be sued, collect judgments, and have all accounting procedures in the name of the partnership entity [UPA 201, 307(a)]. As an entity, a partnership may hold the title to real or personal property in its name rather than in the names of the individual partners. Additionally, federal procedural laws permit the partnership to be treated as an entity in suits in federal courts and bankruptcy proceedings.

Tax Treatment of Partnerships

Modern law does treat a partnership as an aggregate of the individual partners rather than a separate legal entity in one situation—for federal income tax purposes. The partnership is a pass-through entity and not a taxpaying entity. A **pass-through entity**

2. See, for example, *In re Estate of Ivanchak*, 169 Ohio App.3d 140, 862 N.E.2d 151 (2006).

is a business entity that has no tax liability; the entity's income is passed through to the owners of the entity, who pay taxes on it. Thus, the income or losses the partnership incurs are "passed through" the entity framework and attributed to the partners on their individual tax returns. The partnership itself pays no taxes and is responsible only for filing an **information return** with the Internal Revenue Service. A partner's profit from the partnership (whether distributed or not) is taxed as individual income to the individual partner.

SECTION 2 PARTNERSHIP FORMATION

As a general rule, agreements to form a partnership can be *oral, written, or implied by conduct*. Some partnership agreements, however, must be in writing (or an electronic record) to be legally enforceable under the Statute of Frauds (see Chapter 15 for details). For example, a partnership agreement that authorizes the partners to deal in transfers of real property must be evidenced by a sufficient writing (or record).

The Partnership Agreement

A partnership agreement, also known as **articles of partnership**, can include almost any terms that the parties wish, unless they are illegal or contrary to public policy or statute [UPA 103]. The terms commonly included in a partnership agreement are listed in Exhibit 37-1 below.

Duration of the Partnership

The partnership agreement can specify the duration of the partnership by stating that it will continue until a designated date or until the completion of a particular project. This is called a *partnership for a term*. Generally, withdrawal from a partnership for a term prematurely (before the expiration date) constitutes a breach of the agreement, and the responsible partner can be held liable for any resulting losses [UPA 602(b)(2)].

If no fixed duration is specified, the partnership is a *partnership at will*. Any partner can dissolve this type of partnership at any time without violating the agreement and without incurring liability for losses to other partners that result from the termination.

EXHIBIT 37-1 • Terms Commonly Included in a Partnership Agreement

TERM	DESCRIPTION
Basic Structure	• Name of the partnership. • Names of the partners. • Location of the business and the state law under which the partnership is organized. • Purpose of the partnership. • Duration of the partnership.
Capital Contributions	• Amount of capital that each partner is contributing. • The agreed-on value of any real or personal property that is contributed instead of cash. • How gains and losses on contributed capital will be allocated and whether contributions will earn interest.
Sharing of Profits and Losses	• Percentage of the profits and losses of the business that each partner will receive. • When distributions of profit will be made and how net profit will be calculated.
Management and Control	• How management responsibilities will be divided among the partners. • Name(s) of the managing partner or partners and whether other partners have voting rights.
Accounting and Partnership Records	• Name of the bank in which the partnership will maintain its business and checking accounts. • Statement that an accounting of partnership records will be maintained and that any partner, or her or his agent, can review these records at any time. • The dates of the partnership's fiscal year (if used) and when the annual audit of the books will take place.
Dissociation and Dissolution	• Events that will cause the dissociation of a partner or dissolve the partnership, such as the retirement, death, or incapacity of any partner. • How partnership property will be valued and apportioned on dissociation and dissolution. • Whether an arbitrator will determine the value of partnership property on dissociation and dissolution and whether that determination will be binding.
Arbitration	• Whether arbitration is required for any dispute relating to the partnership agreement.

Partnership by Estoppel

Occasionally, persons who are not partners nevertheless hold themselves out as partners and make representations that third parties rely on in dealing with them. In such a situation, a court may conclude that a **partnership by estoppel** exists and impose liability—but not partnership *rights*—on the alleged partner or partners. Similarly, a partnership by estoppel may be imposed when a partner represents, expressly or impliedly, that a nonpartner is a member of the firm. Whenever a third person has reasonably and detrimentally relied on the representation that a nonpartner was part of the partnership, a partnership by estoppel is deemed to exist. When this occurs, the nonpartner is regarded as an agent whose acts are binding on the partnership [UPA 308].

CASE IN POINT Gary Chavers operated Chavers Welding and Construction (CWC). Gary's two sons began to work in the business after graduating from high school. CWC contracted with Epsco, Inc., to provide payroll services for CWC. Epsco extended credit to CWC, which the Chaverses represented was a partnership. When CWC's account was more than \$80,000 delinquent, Epsco sued to recover payment. The father filed for bankruptcy, and his obligation to Epsco was discharged. The sons claimed that their father owned CWC as a sole proprietor and that they were not partners in the business. The court, however, held that the sons were liable for CWC's debts based on partnership by estoppel. Because the Chaverses had represented to Epsco that CWC was a partnership and Epsco had relied on this representation when extending credit, the sons were prevented from claiming that no partnership existed.³

SECTION 3 PARTNERSHIP OPERATION

The rights and duties of partners are governed largely by the specific terms of their partnership agreement. In the absence of provisions to the contrary in the partnership agreement, the law imposes the rights and duties discussed in the following subsections. The character and nature of the partnership business generally influence the application of these rights and duties.

3. *Chavers v. Epsco, Inc.*, 352 Ark. 65, 98 S.W.3d 421 (2003).

Rights of Partners

The rights of partners in a partnership relate to the following areas: management, interest in the partnership, compensation, inspection of books, accounting, and property.

MANAGEMENT In a general partnership, all partners have equal rights in managing the partnership [UPA 401(f)]. Unless the partners agree otherwise, each partner has one vote in management matters *regardless of the proportional size of his or her interest in the firm*. In a large partnership, partners often agree to delegate daily management responsibilities to a management committee made up of one or more of the partners.

The majority rule controls decisions on ordinary matters connected with partnership business, unless otherwise specified in the agreement. Decisions that significantly affect the nature of the partnership or that are outside the ordinary course of the partnership business, however, require the *unanimous* consent of the partners [UPA 301(2), 401(i), 401(j)].

Unanimous consent is likely to be required for a decision to undertake any of the following actions:

1. To alter the essential nature of the firm's business as expressed in the partnership agreement or to alter the capital structure of the partnership.
2. To admit new partners or engage in a completely new business.
3. To assign partnership property to a trust for the benefit of creditors.
4. To dispose of the partnership's *goodwill* (defined on page 720).
5. To confess judgment against the partnership or to submit partnership claims to arbitration. (A **confession of judgment** is an act by a debtor that permits a judgment to be entered against him or her by a creditor, for an agreed sum, without the institution of legal proceedings.)
6. To undertake any act that would make further conduct of partnership business impossible.
7. To amend the terms of the partnership agreement.

INTEREST IN THE PARTNERSHIP Each partner is entitled to the proportion of business profits and losses that is specified in the partnership agreement. If the agreement does not apportion profits (indicate how the profits will be shared), the UPA provides that profits will be shared equally. If the agreement does not apportion losses, losses will be shared in the same ratio as profits [UPA 401(b)].

For example, Rico and Brett form a partnership. The partnership agreement provides for capital

contributions of \$60,000 from Rico and \$40,000 from Brett, but it is silent as to how they will share profits or losses. In this situation, they will share both profits and losses equally. If their partnership agreement had provided that they would share profits in the same ratio as capital contributions, however, 60 percent of the profits would go to Rico, and 40 percent would go to Brett. If this agreement was silent as to losses, losses would be shared in the same ratio as profits (60 percent and 40 percent, respectively).

COMPENSATION Devoting time, skill, and energy to partnership business is a partner's duty and generally is not a compensable service. Rather, as mentioned, a partner's income from the partnership takes the form of a distribution of profits according to the partner's share in the business. Partners can, of course, agree otherwise. For example, the managing partner of a law firm often receives a salary—in addition to her or his share of profits—for performing special administrative or managerial duties.

INSPECTION OF THE BOOKS Partnership books and records must be kept accessible to all partners. Each partner has the right to receive (and the corresponding duty to produce) full and complete information concerning the conduct of all aspects of partnership business [UPA 403]. Each firm retains books for recording and securing such information. Partners contribute the information, and a bookkeeper typically has the duty to preserve it. The books must be kept at the firm's principal business office (unless the partners agree otherwise). Every partner, whether active or inactive, is entitled to inspect all books and records on demand and can make copies of the materials. The personal representative of a deceased partner's estate has the same right of access to partnership books and records that the decedent would have had [UPA 403].

ACCOUNTING OF PARTNERSHIP ASSETS OR PROFITS An accounting of partnership assets or profits is required to determine the value of each partner's share in the partnership. An accounting can be performed voluntarily, or it can be compelled by court order. Under UPA 405(b), a partner has the right to bring an action for an accounting during the term of the partnership, as well as on the partnership's dissolution and winding up.

PROPERTY RIGHTS Property acquired by a partnership is the property of the partnership and not of the partners individually [UPA 203]. Partnership property includes all property that was originally

contributed to the partnership and anything later purchased by the partnership or in the partnership's name (except in rare circumstances) [UPA 204]. A partner may use or possess partnership property only on behalf of the partnership [UPA 401(g)]. A partner is *not* a co-owner of partnership property and has no right to sell, mortgage, or transfer partnership property to another [UPA 501].⁴

In other words, partnership property is owned by the partnership as an entity and not by the individual partners. Thus, a creditor of an individual partner cannot seek to use partnership property to satisfy the partner's debt. Such a creditor can, however, petition a court for a **charging order** to attach the individual partner's *interest* in the partnership (her or his proportionate share of the profits and losses and right to receive distributions) to satisfy the partner's obligation [UPA 502]. A partner can also assign her or his right to a share of the partnership profits to another to satisfy a debt.

Duties and Liabilities of Partners

The duties and liabilities of partners that we examine here are basically derived from agency law. Each partner is an agent of every other partner and acts as both a principal and an agent in any business transaction within the scope of the partnership agreement. Each partner is also a general agent of the partnership in carrying out the usual business of the firm "or business of the kind carried on by the partnership" [UPA 301(1)]. Thus, every act of a partner concerning partnership business and "business of the kind" and every contract signed in the partnership's name bind the firm. The UPA affirms general principles of agency law that pertain to the authority of a partner to bind a partnership in contract or tort.

FIDUCIARY DUTIES The fiduciary duties that a partner owes to the partnership and the other partners are the duty of care and the duty of loyalty [UPA 404(a)]. Under the UPA, a partner's *duty of care* is limited to refraining from "grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law" [UPA 404(c)].⁵ A partner is not

4. Under the previous version of the UPA, partners were *tenants in partnership*. This meant that every partner was a co-owner with all other partners of the partnership property. The current UPA does not recognize this concept.

5. The previous version of the UPA touched only briefly on the duty of loyalty and left the details of the partners' fiduciary duties to be developed under the law of agency.

liable to the partnership for simple negligence or honest errors in judgment in conducting partnership business.

The *duty of loyalty* requires a partner to account to the partnership for “any property, profit, or benefit” derived by the partner in the conduct of the partnership’s business or from the use of its property. A

partner must also refrain from competing with the partnership in business or dealing with the firm as an adverse party [UPA 404(b)]. The duty of loyalty can be breached by self-dealing, misusing partnership property, disclosing trade secrets, or usurping a partnership business opportunity. The following case is a classic example.



CASE 37.1 Meinhard v. Salmon

Court of Appeals of New York, 249 N.Y. 458, 164 N.E. 545 (1928).
www.nycourts.gov/reporter/Index.htm^a

BACKGROUND AND FACTS • Walter Salmon negotiated a twenty-year lease for the Hotel Bristol in New York City. To pay for the conversion of the building into shops and offices, Salmon entered into an agreement with Morton Meinhard to assume half of the cost. They agreed to share the profits and losses from the *joint venture* (see page 746), but Salmon was to have the sole power to manage the building. Less than four months before the end of the lease term, the building’s owner, Elbridge Gerry, approached Salmon about a project to raze the converted structure, clear five adjacent lots, and construct a single building across the whole property. Salmon agreed and signed a new lease in the name of his own business, Midpoint Realty Company, without telling Meinhard. When Meinhard learned of the deal, he filed a suit in a New York state court against Salmon. The court ruled in Meinhard’s favor, and Salmon appealed.



IN THE LANGUAGE OF THE COURT CARDOZO, C.J. [Chief Justice]

* * *

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a work-a-day world for those acting at arm’s length are forbidden to those bound by fiduciary ties. * * * Not honesty alone, but the punctilio [strictness in observance of details] of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate [entrenched]. Uncompromising rigidity has been the attitude of courts * * * when petitioned to undermine the rule of undivided loyalty.

* * * The trouble about [Salmon’s] conduct is that he excluded his coadventurer from any chance to compete, from any chance to enjoy the opportunity for benefit.

* * * The very fact that Salmon was in control with exclusive powers of direction charged him the more obviously with the duty of disclosure, [because] only through disclosure could opportunity be equalized.

* * * Authority is, of course, abundant that one partner may not appropriate to his own use a renewal of a lease, though its term is to begin at the expiration of the partnership. The lease at hand with its many changes is not strictly a renewal. Even so, the standard of loyalty for those in trust relations is without the fixed divisions of a graduated scale. * * * *A man obtaining [an] * * * opportunity * * * by the position he occupies as a partner is bound by his obligation to his copartners in such dealings not to separate his interest from theirs, but, if he acquires any benefit, to communicate it to them. Certain it is also that there may be no abuse of special opportunities growing out of a special trust as manager or agent.* [Emphasis added.]

* * * Very likely [Salmon] assumed in all good faith that with the approaching end of the venture he might ignore his coadventurer and take the extension for himself. He had given to the enterprise time and labor as well as money. He had made it a success. Meinhard, who had given money, but neither time nor labor, had already been richly paid. * * * [But] Salmon had put himself in a position in which thought of self was to be renounced, however hard the

a. In the links at the bottom of the page, click on “Archives.” In the result, scroll to the name of the case and click on it to access the opinion. The New York State Law Reporting Bureau maintains this Web site.

CASE 37.1 CONTINUED ♦ abnegation [self-denial]. He was much more than a coadventurer. He was a managing coadventurer. For him and for those like him the rule of undivided loyalty is relentless and supreme.

DECISION AND REMEDY • *The Court of Appeals of New York held that Salmon breached his fiduciary duty by failing to inform Meinhard of the business opportunity and secretly taking advantage of it himself. The court granted Meinhard an interest "measured by the value of half of the entire lease."*

WHAT IF THE FACTS WERE DIFFERENT? • *Suppose that Salmon had disclosed Gerry's proposal to Meinhard, who had said that he was not interested. Would the result in this case have been different? Explain.*

IMPACT OF THIS CASE ON TODAY'S LAW • *This landmark case involved a joint venture, not a partnership. At the time, a member of a joint venture had only the duty to refrain from actively subverting the rights of the other members. The decision in this case imposed the highest standard of loyalty on joint-venture members. The duty is now the same in both joint ventures and partnerships. The eloquent language in this case that describes the standard of loyalty is frequently quoted approvingly by courts in cases involving partnerships.*

BREACH AND WAIVER OF FIDUCIARY DUTIES A partner's fiduciary duties may not be waived or eliminated in the partnership agreement, and in fulfilling them each partner must act consistently with the obligation of good faith and fair dealing [UPA 103(b), 404(d)]. The agreement can specify acts that the partners agree will violate a fiduciary duty.

Note that a partner may pursue his or her own interests without automatically violating these duties [UPA 404(e)]. The key is whether the partner has disclosed the interest to the other partners. For example, a partner who owns a shopping mall may vote against a partnership proposal to open a competing mall, provided that the partner has fully disclosed her interest in the existing shopping mall to the other partners at the firm. A partner cannot make secret profits or put self-interest before his or her duty to the interest of the partnership, however.

AUTHORITY OF PARTNERS The UPA affirms general principles of agency law that pertain to a partner's authority to bind a partnership in contract. A partner may also subject the partnership to tort liability under agency principles. When a partner is carrying on partnership business or business of the kind with third parties in the usual way, apparent authority exists, and both the partner and the firm share liability.

The partnership will not be liable, however, if the third parties *know* that the partner has no such authority. For example, Patricia, a partner in a law firm, applies for a bank loan on behalf of the partnership without authorization from the other partners. If the bank manager knows that Patricia has no

authority to do so and nonetheless grants the loan, Patricia will be personally bound, but the partnership will not be liable.

A partnership may file in a designated state office a "statement of partnership authority" to limit a partner's capacity to act as the firm's agent or transfer property on its behalf [UPA 105, 303]. Any such limit on a partner's authority, however, normally does not affect a third party who does not know about the statement (except in real estate transactions when the statement has been recorded with the appropriate state office—see Chapter 50).

The agency concepts relating to apparent authority, actual authority, and ratification that were discussed in Chapter 33 also apply to partnerships. The extent of *implied authority* generally is broader for partners than for ordinary agents, however.

The Scope of Implied Powers. The character and scope of the partnership business and the customary nature of the particular business operation determine the implied powers of partners. For example, a *trading partnership* is a business that has goods in inventory and makes profits buying and selling those goods. A partner in a trading partnership has a wide range of implied powers, such as to advertise products, hire employees, and extend the firm's credit by issuing or signing checks (see Chapter 26).

In an ordinary partnership, the partners can exercise all implied powers reasonably necessary and customary to carry on that particular business. Some customarily implied powers include the authority to make warranties on goods in the sales business and the power to enter into contracts consistent with

the firm's regular course of business. Most partners also have the implied authority to make admissions and representations concerning partnership affairs. A partner might also have the implied power to convey (transfer) real property in the firm's name when such conveyances are part of the ordinary course of partnership business.

Authorized versus Unauthorized Actions. If a partner acts within the scope of authority, the partnership is legally bound to honor the partner's commitments to third parties. For example, a partner's authority to sell partnership products carries with it the implied authority to transfer title and to make usual warranties. Hence, in a partnership that operates a retail tire store, any partner negotiating a contract with a customer for the sale of a set of tires can specify that "each tire will be warranted for normal wear for 40,000 miles." This same partner, however, does not have the authority to sell office equipment, fixtures, or the partnership's retail facility without the consent of all of the other partners.

In addition, because partnerships are formed to generate profits, a partner generally does not have the authority to make charitable contributions without the consent of the other partners. Such actions are not binding on the partnership unless they are ratified by all of the other partners.

LIABILITY OF PARTNERS One significant disadvantage associated with a traditional partnership is that the partners are *personally* liable for the debts of the partnership. Moreover, in most states, the liability is essentially unlimited because the acts of one partner in the ordinary course of business subject the other partners to personal liability [UPA 305]. The following subsections explain the rules on a partner's liability.

Joint Liability. At one time, each partner in a partnership generally was jointly liable for the partnership's obligations. **Joint liability** means that a third party must sue all of the partners as a group, but each partner can be held liable for the full amount.⁶ If a third party sued a partner on a contractual debt, the lawsuit had to name all of the

partners as defendants to seek partnership assets to pay any judgment. With joint liability, the partnership's assets must be exhausted before creditors can reach the partners' individual assets.⁷

Joint and Several Liability. In the majority of the states, under UPA 306(a), partners are both jointly and severally (separately, or individually) liable for all partnership obligations, including contracts, torts, and breaches of trust. **Joint and several liability** means that a third party has the option of suing all of the partners together (jointly) or one or more of the partners separately (severally). This is true even if a partner did not participate in, ratify, or know about whatever it was that gave rise to the cause of action. Normally, though, the partnership's assets must be exhausted before a creditor can enforce a judgment against a partner's separate assets [UPA 307(d)].

A judgment against one partner severally (separately) does not extinguish the others' liability. Those not sued in the first action normally may be sued subsequently, unless the court in the first action held that the partnership was in no way liable. If a plaintiff is successful in a suit against a partner or partners, he or she may collect on the judgment only against the assets of those partners named as defendants. A partner who commits a tort may be required to indemnify (reimburse) the partnership for any damages it pays—unless the tort was committed in the ordinary course of the partnership's business.

CASE IN POINT Nicole Moren was a partner in Jax Restaurant. After work one day, Moren was called back to the restaurant to help in the kitchen. She brought her two-year-old-son, Remington, and sat him on the kitchen counter. While she was making pizzas, Remington reached into the dough press. His hand was crushed, causing permanent injuries. Through his father, Remington filed a suit against the partnership for negligence. The partnership filed a complaint against Moren, arguing that it was entitled to indemnity (compensation or reimbursement) from Moren for her negligence. The court held in favor of Moren and ordered the partnership to pay damages to Remington. Moren was not required to indemnify the partnership because her negligence occurred in the ordinary course of the partnership's business.⁸

6. Under the previous version of the UPA, which is still in effect in a few states, partners were subject to joint liability on partnership debts and contracts, excluding partnership debts arising from torts. States that still follow the previous version of the UPA include Connecticut, West Virginia, and Wyoming. In these states, the partners are subject to *joint liability* on contracts and to *joint and several liability* (discussed next) on debts arising from torts.

7. For a case applying joint liability to a partnership, see *Shar's Cars, LLC v. Elder*, 97 P.3d 724 (Utah App. 2004).

8. *Moren v. Jax Restaurant*, 679 N.W.2d 165 (Minn.App. 2004).

Liability of Incoming Partners. A partner newly admitted to an existing partnership is not personally liable for any partnership obligation incurred before the person became a partner [UPA 306(b)]. In other words, the new partner's liability to existing creditors of the partnership is limited to her or his capital contribution to the firm.

For example, Smartclub, an existing partnership with four members, admits a new partner, Alex Jaff. He contributes \$100,000 to the partnership. Smartclub has debts amounting to \$600,000 at the time Jaff joins the firm. Although Jaff's capital contribution of \$100,000 can be used to satisfy Smartclub's obligations, Jaff is not personally liable for partnership debts that were incurred before he became a partner. Thus, his personal assets cannot be used to satisfy the partnership's preexisting debt. If, however, the managing partner at Smartclub borrows funds for the partnership after Jaff becomes a partner, Jaff will be personally liable for those amounts, along with all other partners.

SECTION 4 DISSOCIATION OF A PARTNER

Dissociation occurs when a partner ceases to be associated in the carrying on of the partnership business. Although a partner always has the *power* to dissociate from the firm, he or she may not have the *right* to dissociate. Dissociation normally entitles the partner to have his or her interest purchased by the partnership, and terminates his or her actual authority to act for the partnership and to participate with the partners in running the business. After that, the partnership continues to do business without the dissociated partner.⁹

Events That Cause Dissociation

Under UPA 601, a partner can be dissociated from a partnership in any of the following ways:

1. By the partner's voluntarily giving notice of an "express will to withdraw." (Note that when a partner gives notice of her or his intent to withdraw, the remaining partners must decide whether
9. Under the previous version of the UPA, when a partner withdrew from a partnership, the partnership was considered dissolved, its business had to be wound up, and the proceeds had to be distributed to creditors and among partners. The new UPA provisions dramatically changed the law governing partnership breakups and dissolution by no longer requiring that the partnership end if one partner dissociates.

to continue or give up the partnership business. If they do not agree to continue the partnership, the voluntary dissociation of a partner will dissolve the firm [UPA 801(1)].

2. By the occurrence of an event specified in the partnership agreement.
3. By a unanimous vote of the other partners under certain circumstances, such as when a partner transfers substantially all of her or his interest in the partnership, or when it becomes unlawful to carry on partnership business with that partner.
4. By order of a court or arbitrator if the partner has engaged in wrongful conduct that affects the partnership business, breached the partnership agreement or violated a duty owed to the partnership or the other partners, or engaged in conduct that makes it "not reasonably practicable to carry on the business in partnership with the partner" [UPA 601(5)].
5. By the partner's declaring bankruptcy, assigning his or her interest in the partnership for the benefit of creditors, or becoming physically or mentally incapacitated, or by the partner's death. Note that although the bankruptcy or death of a partner represents that partner's "dissociation" from the partnership, it is not an *automatic* ground for the partnership's dissolution (*dissolution* will be discussed shortly).

Wrongful Dissociation

As mentioned, a partner has the power to dissociate from a partnership at any time, but if she or he lacks the right to dissociate, then the dissociation is considered wrongful under the law [UPA 602]. When a partner's dissociation breaches a partnership agreement, for instance, it is wrongful. Suppose that a partnership agreement states that it is a breach of the agreement for any partner to assign partnership property to a creditor without the consent of the other partners. If Janis, a partner, makes such an assignment, she has not only breached the agreement but has also wrongfully dissociated from the partnership. Similarly, if a partner refuses to perform duties required by the partnership agreement—such as accounting for profits earned from the use of partnership property—this breach can be treated as a wrongful dissociation.

A partner who wrongfully dissociates is liable to the partnership and to the other partners for damages caused by the dissociation. This liability is in addition to any other obligation of the partner to the partnership or to the other partners. Thus, a wrongfully dissociating partner is liable to the partnership

not only for any damages caused by breach of the partnership agreement, but also for costs incurred to replace the partner's expertise or to obtain new financing.

Effects of Dissociation

Dissociation (rightful or wrongful) terminates some of the rights of the dissociated partner, requires that the partnership purchase his or her interest, and alters the liability of the parties to third parties.

RIGHTS AND DUTIES On a partner's dissociation, his or her right to participate in the management and conduct of the partnership business terminates [UPA 603]. The partner's duty of loyalty also ends. A partner's duty of care continues only with respect to events that occurred before dissociation, unless the partner participates in winding up the partnership's business (which will be discussed shortly). For example, Debbie Pearson is a partner who is leaving an accounting firm, Bubbs & Pearson. Pearson can immediately compete with the firm for new clients. She must exercise care in completing ongoing client transactions, however, and must account to the firm for any fees received from the old clients based on those transactions.

After a partner's dissociation, his or her interest in the partnership must be purchased according to the rules in UPA 701. The **buyout price** is based on the amount that would have been distributed to the partner if the partnership had been wound up on the date of dissociation. Offset against the price are amounts owed by the partner to the partnership, including damages for wrongful dissociation.

CASE IN POINT In 1978, Wilbur and Dee Warnick and their son Randall bought a ranch for \$335,000 and formed a partnership to operate it. The partners' initial capital contributions totaled \$60,000, of which Randall paid 34 percent. Over the next twenty years, each partner contributed funds to the operation and received cash distributions from the partnership. In 1999, Randall dissociated from the partnership. When the parties could not agree on a buyout price, Randall filed a lawsuit. The court awarded Randall \$115,783.13—the amount of his cash contributions, plus 34 percent of the increase in the value of the partnership's assets above all partners' cash contributions. Randall's parents appealed, arguing that \$50,000 should be deducted from the appraised value of the assets for the estimated expenses of selling them. The court affirmed the buyout price, however,

because "purely hypothetical costs of sale are not a required deduction in valuing partnership assets" to determine a buyout price.¹⁰

LIABILITY TO THIRD PARTIES For two years after a partner dissociates from a continuing partnership, the partnership may be bound by the acts of the dissociated partner based on apparent authority [UPA 702]. In other words, the partnership may be liable to a third party with whom a dissociated partner enters into a transaction if the third party reasonably believed that the dissociated partner was still a partner. Similarly, a dissociated partner may be liable for partnership obligations entered into during a two-year period following dissociation [UPA 703].

To avoid this possible liability, a partnership should notify its creditors, customers, and clients of a partner's dissociation. In addition, either the partnership or the dissociated partner can file a statement of dissociation in the appropriate state office to limit the dissociated partner's authority to ninety days after the filing [UPA 704]. Filing this statement helps to minimize the firm's potential liability for the former partner and vice versa.

SECTION 5 PARTNERSHIP TERMINATION

The same events that cause dissociation can result in the end of the partnership if the remaining partners no longer wish to (or are unable to) continue the partnership business. Only certain departures of a partner will end the partnership, though, and generally the partnership can continue if the remaining partners consent [UPA 801].

The termination of a partnership is referred to as **dissolution**, which essentially means the commencement of the winding up process. **Winding up** is the actual process of collecting, liquidating, and distributing the partnership assets.¹¹ Here, we discuss the dissolution and winding up of partnership business.

Dissolution

Dissolution of a partnership generally can be brought about by acts of the partners, by operation of law,

10. *Warnick v. Warnick*, 2006 WY 58, 133 P.3d 997 (2006).

11. Although "winding down" would seem to describe more accurately the process of settling accounts and liquidating the assets of a partnership, English and U.S. statutory and case law have traditionally used "winding up" to denote this final stage of a partnership's existence.

or by judicial decree [UPA 801]. Any partnership (including one for a fixed term) can be dissolved by the partners' agreement. Similarly, if the partnership agreement states that it will dissolve on a certain event, such as a partner's death or bankruptcy, then the occurrence of that event will dissolve the partnership. A partnership for a fixed term or a particular undertaking is dissolved by operation of law at the expiration of the term or on the completion of the undertaking.

Any event that makes it unlawful for the partnership to continue its business will result in dissolution [UPA 801(4)]. Under the UPA, a court may order dissolution when it becomes obviously impractical for the firm to continue—for example, if the business can only be operated at a loss [UPA 801(5)]. Note, however, that even when one partner has brought a court action seeking to dissolve a partnership, the partnership continues to exist until it is legally dissolved by the court or by the parties' agreement.

CASE IN POINT Ellin Curley and Lawrence Kaiser were married when they formed a general partnership, K&K Associates. Later, Curley and Kaiser were divorced and entered into an amended partnership agreement that stated that Curley owned 80 percent of the firm and Kaiser owned 20 percent. K&K invested part of its capital, but the investment suffered losses. When Kaiser refused to pay his share of the losses, Curley filed a suit for breach of contract and requested judicial dissolution of K&K. While the lawsuit was pending, Kaiser died, and his new wife was substituted as the defendant. A provision in the amended agreement stated that if Kaiser died while still a partner, K&K would terminate, and the value of Kaiser's ownership interest in the closing capital account would be zero. The defense argued that this provision was not enforceable because the partnership no longer existed. The court ruled that although the dissolution process had begun, the partnership still existed when Kaiser died. Therefore, the provision in the amended agreement effectively terminated the partnership and reduced the value of Kaiser's interest to zero.¹²

Winding Up and Distribution of Assets

After dissolution, the partnership continues for the limited purpose of the winding up process.¹³ The

partners cannot create new obligations on behalf of the partnership. They have authority only to complete transactions begun but not finished at the time of dissolution and to wind up the business of the partnership [UPA 803, 804(1)].

Winding up includes collecting and preserving partnership assets, discharging liabilities (paying debts), and accounting to each partner for the value of his or her interest in the partnership. Partners continue to have fiduciary duties to one another and to the firm during this process. UPA 401(h) provides that a partner is entitled to compensation for services in winding up partnership affairs (and reimbursement for expenses incurred in the process) above and apart from his or her share in the partnership profits.

Both creditors of the partnership and creditors of the individual partners can make claims on the partnership's assets. In general, partnership creditors share proportionately with the partners' individual creditors in the partners' assets, which include their interests in the partnership. A partnership's assets are distributed according to the following priorities [UPA 807]:

1. Payment of debts, including those owed to partner and nonpartner creditors.
2. Return of capital contributions and distribution of profits to partners.¹⁴

If the partnership's liabilities are greater than its assets, the partners bear the losses—in the absence of a contrary agreement—in the same proportion in which they shared the profits (rather than, for example, in proportion to their contributions to the partnership's capital).

Partnership Buy-Sell Agreements

Before entering into a partnership, partners should agree on how the assets will be valued and divided in the event that the partnership dissolves. A **buy-sell agreement**, sometimes called simply a *buyout agreement*, provides for one or more partners to buy out the other or others, should the situation warrant. Agreeing beforehand on who buys what, under what circumstances, and, if possible, at what price may eliminate costly negotiations or litigation later. Alternatively, the agreement may specify that one

12. *Curley v. Kaiser*, 112 Conn.App. 213, 962 A.2d 167 (2009).

13. Note that at any time after dissolution but before winding up is completed, all of the partners may decide to continue the partnership business and waive the right to have the business wound up [UPA 802].

14. Under the previous version of the UPA, creditors of the partnership had priority over creditors of the individual partners. Also, in distributing partnership assets, third party creditors were paid before partner creditors, and capital contributions were returned before profits.

or more partners will determine the value of the interest being sold and that the other or others will decide whether to buy or sell.

Under UPA 701(a), if a partner's dissociation does not result in a dissolution of the partnership, a buyout of the partner's interest is mandatory. The UPA contains an extensive set of buyout rules that apply when the partners do not have a buyout agreement. Basically, a withdrawing partner receives the same amount through a buyout that he or she would receive if the business were winding up [UPA 701(b)].

SECTION 6 LIMITED LIABILITY PARTNERSHIPS

The **limited liability partnership (LLP)** is a hybrid form of business designed mostly for professionals who normally do business as partners in a partnership. The first state to enact an LLP statute was Texas, in 1991. Other states quickly followed suit, and by 1997, almost all of the states had enacted LLP statutes.

The major advantage of the LLP is that it allows a partnership to continue as a pass-through entity for tax purposes but limits the personal liability of the partners. The LLP is especially attractive for two categories of businesses: professional service firms and family businesses. In fact, all of the "Big Four" accounting firms—the four largest international accountancy and professional services firms—are organized as LLPs, including Ernst & Young, LLP, and PricewaterhouseCoopers, LLP.

Formation of an LLP

LLPs must be formed and operated in compliance with state statutes, which may include provisions of the UPA. The appropriate form must be filed with a central state agency, usually the secretary of state's office, and the business's name must include either "Limited Liability Partnership" or "LLP" [UPA 1001, 1002]. In addition, an LLP must file an annual report with the state to remain qualified as an LLP in that state [UPA 1003].

In most states, it is relatively easy to convert a traditional partnership into an LLP because the firm's basic organizational structure remains the same. Additionally, all of the statutory and common law rules governing partnerships still apply (apart from those modified by the LLP statute). Normally, LLP statutes are simply amendments to a state's already existing partnership law.

Liability in an LLP

An LLP allows professionals, such as attorneys and accountants, to avoid personal liability for the malpractice of other partners. A partner in an LLP is still liable for her or his own wrongful acts, such as negligence, however. Also liable is the partner who supervised the individual who committed a wrongful act. (This generally is true for all types of partners and partnerships, not just LLPs.)

Although LLP statutes vary from state to state, generally each state statute limits the liability of partners in some way. For example, Delaware law protects each innocent partner from the "debts and obligations of the partnership arising from negligence, wrongful acts, or misconduct." The UPA more broadly exempts partners from personal liability for any partnership obligation, "whether arising in contract, tort, or otherwise" [UPA 306(c)]. Although the language of these statutes may seem to apply specifically to attorneys, almost any group of professionals can organize as an LLP.

LIABILITY FROM STATE TO STATE When an LLP formed in one state wants to do business in another state, it may be required to register in the second state—for example, by filing a statement of foreign qualification [UPA 1102]. Because state LLP statutes are not uniform, a question sometimes arises as to which law applies if the LLP statutes in the two states provide different liability protection. Most states apply the law of the state in which the LLP was formed, even when the firm does business in another state, which is also the rule under UPA 1101.

SHARING LIABILITY AMONG PARTNERS When more than one partner in an LLP is negligent, there is a question as to how liability should be shared. Some states provide for proportionate liability—that is, for separate determinations of the negligence of the partners. For example, accountants Don and Jane are partners in an LLP, with Don supervising Jane. Jane negligently fails to file a tax return for one of their clients, Centaur Tools. Centaur files a suit against Don and Jane. Under a proportionate liability statute, Don will be liable for no more than his portion of the responsibility for the missed tax deadline. In a state that does not allow for proportionate liability, Don can be held liable for the entire loss.

Family Limited Liability Partnerships

A **family limited liability partnership (FLLP)** is a limited liability partnership in which the partners are related to each other—for example, as spouses,

parents and children, siblings, or cousins. A person acting in a fiduciary capacity for persons so related can also be a partner. All of the partners must be natural persons or persons acting in a fiduciary capacity for the benefit of natural persons.

Probably the most significant use of the FLLP form of business organization is in agriculture. Family-owned farms sometimes find this form to their benefit. The FLLP offers the same advantages as other LLPs with certain additional advantages, such as, in Iowa, an exemption from real estate transfer taxes when partnership real estate is transferred among partners.¹⁵

SECTION 7 LIMITED PARTNERSHIPS

We now look at a business organizational form that limits the liability of *some* of its owners—the **limited partnership (LP)**. Limited partnerships originated in medieval Europe and have been in existence in the United States since the early 1800s. In many ways, limited partnerships are like the general partnerships discussed at the beginning of this chapter, but they differ from general partnerships in several ways. For this reason, they are sometimes referred to as *special partnerships*.

A limited partnership consists of at least one **general partner** and one or more **limited partners**. A general partner assumes management responsibility for the partnership and has full responsibility for the partnership and for all its debts. A limited partner contributes cash or other property and owns an interest in the firm but does not undertake any management responsibilities and is not personally liable for partnership debts beyond the amount of his or her investment. A limited partner can forfeit limited liability by taking part in the management of the business. A comparison of general partnerships and limited partnerships appears in Exhibit 37-2 on the following page.¹⁶

Until 1976, the law governing limited partnerships in all states except Louisiana was the Uniform Limited Partnership Act (ULPA). Since 1976, most states and the District of Columbia have adopted the revised version of the ULPA, known as the

Revised Uniform Limited Partnership Act (RULPA). Because the RULPA is the dominant law governing limited partnerships in the United States, we refer to it in the following discussion. Note, however, that amendments to make the RULPA more flexible were proposed to the states in 2001, and fifteen states have adopted the 2001 version of this law.

Formation of a Limited Partnership

In contrast to the informal, private, and voluntary agreement that usually suffices for a general partnership, the formation of a limited partnership is a public and formal proceeding that must follow statutory requirements. A limited partnership must have at least one general partner and one limited partner, as mentioned previously. Additionally, the partners must sign a **certificate of limited partnership**, which requires information such as the name, mailing address, and capital contribution of each general and limited partner. (The information required is similar to that found in a corporation's *articles of incorporation*—see Chapter 39.) The certificate must be filed with the designated state official—under the RULPA, the secretary of state. The certificate is usually open to public inspection.

Liabilities of Partners in a Limited Partnership

General partners, unlike limited partners, are personally liable to the partnership's creditors. Thus, at least one general partner is necessary in a limited partnership so that someone has personal liability. This policy can be circumvented in states that allow a corporation to be the general partner in a partnership. Because the corporation has limited liability by virtue of corporation statutes, if a corporation is the general partner, no one in the limited partnership has personal liability.

The liability of a limited partner, as mentioned, is limited to the capital that she or he contributes or agrees to contribute to the partnership [RULPA 502]. Limited partners enjoy this limited liability only so long as they do not participate in management [RULPA 303]. A limited partner who participates in management will be just as liable as a general partner to any creditor who transacts business with the limited partnership and believes, based on the limited partner's conduct, that the limited partner is a general partner [RULPA 303]. It is not always clear how much review and advisement a limited partner can engage in before being exposed to liability, though.

15. Iowa Statutes Section 428A.2.

16. Under the UPA, a general partnership can be converted into a limited partnership and vice versa [UPA 902, 903]. The UPA also provides for the merger of a general partnership with one or more general or limited partnerships [UPA 905].

EXHIBIT 37-2 • A Comparison of General Partnerships and Limited Partnerships

CHARACTERISTIC	GENERAL PARTNERSHIP (UPA)	LIMITED PARTNERSHIP (RULPA)
Creation	By agreement of two or more persons to carry on a business as co-owners for profit.	By agreement of two or more persons to carry on a business as co-owners for profit. Must include one or more general partners and one or more limited partners. Filing of a certificate with the secretary of state is required.
Sharing of Profits and Losses	By agreement; or, in the absence of agreement, profits are shared equally by the partners, and losses are shared in the same ratio as profits.	Profits are shared as required in the certificate agreement, and losses are shared likewise, up to the amount of the limited partners' capital contributions. In the absence of a provision in the certificate agreement, profits and losses are shared on the basis of percentages of capital contributions.
Liability	Unlimited personal liability of all partners.	Unlimited personal liability of all general partners; limited partners liable only to the extent of their capital contributions.
Capital Contribution	No minimum or mandatory amount; set by agreement.	Set by agreement.
Management	By agreement; or, in the absence of agreement, all partners have an equal voice.	Only the general partner (or the general partners). Limited partners have no voice or else are subject to liability as general partners (but only if a third party has reason to believe that the limited partner is a general partner). A limited partner may act as an agent or employee of the partnership and vote on amending the certificate or on the sale or dissolution of the partnership.
Duration	Terminated by agreement of the partners, but can continue to do business even when a partner dissociates from the partnership.	Terminated by agreement in the certificate or by retirement, death, or mental incompetence of a general partner in the absence of the right of the other general partners to continue the partnership. Death of a limited partner does not terminate the partnership, unless he or she is the only remaining limited partner.
Distribution of Assets on Liquidation—Order of Priorities	1. Payment of debts, including those owed to partner and nonpartner creditors. 2. Return of capital contributions and distribution of profit to partners.	1. Outside creditors and partner creditors. 2. Partners and former partners entitled to distributions of partnership assets. 3. Unless otherwise agreed, return of capital contributions and distribution of profit to partners.

Rights and Duties in a Limited Partnership

With the exception of the right to participate in management, limited partners have essentially the same rights as general partners. Limited partners have a right of access to the partnership's books and to information regarding partnership business. On dissolution of the partnership, limited partners are entitled to a return of their contributions in accordance with the partnership certificate

[RULPA 201(a)(10)]. They can also assign their interests subject to the certificate [RULPA 702, 704] and can sue an outside party on behalf of the firm if the general partners with authority to do so have refused to file suit [RULPA 1001].

General and limited partners also owe each other a fiduciary duty to exercise good faith in transactions related to the partnership. Can this duty be waived through a provision in the partnership agreement? That was the issue in the following case.

**CASE 37.2****1515 North Wells, LP v. 1513 North Wells, LLC**

Appellate Court of Illinois, First District, 392 Ill.App.3d 863, 913 N.E.2d 1 (2009).

BACKGROUND AND FACTS • Thomas Bracken (owner of 1513 North Wells, LLC), Mark Sutherland, and Alex Pearsall were limited partners in 1515 North Wells, LP. Sutherland and Pearsall's company, SP Development Corporation, was 1515's general partner. The partnership was formed to build a condominium with residential and commercial space. SP chose another Sutherland and Pearsall company, Sutherland and Pearsall Development, to be the general contractor for the 1515 project. Meanwhile, Bracken borrowed \$250,000 from 1515. When he did not repay the loan, 1515 filed a suit in an Illinois state court to collect. In response, Bracken filed a claim that included SP Development Corporation, alleging breach of fiduciary duty. The court ordered Bracken to repay the loan and SP to pay Bracken \$900,000. SP appealed, arguing that a provision in 1515's partnership agreement, which allowed all partners to engage in "whatever activities they choose," effectively "relaxed" SP's fiduciary duty.

**IN THE LANGUAGE OF THE COURT**

Justice **CAHILL** delivered the opinion of the court:

* * * *

* * * Paragraph 1.7 of the limited partnership agreement * * * provided:

The General Partner and each Limited Partner may, notwithstanding this Agreement, engage in whatever activities they choose, whether the same are competitive with the Partnership or otherwise, without having or incurring any obligation to offer any interest in such activities to the Partnership or any Partner.

* * * *

The general partner argues that paragraph 1.7 did in fact relax the parties' fiduciary duties to each other.

* * * *

A fiduciary relationship exists between partners and each is bound to exercise the utmost good faith in all dealings and transactions related to the partnership. To state a claim for breach of fiduciary duty, a plaintiff must establish (1) a fiduciary duty on the part of the defendant, (2) the defendant's breach of that duty, and (3) damages that were proximately caused by the defendant's breach.

Under Section 103(b)(3) of the Uniform Partnership Act, a partnership agreement may not "eliminate or reduce a partner's fiduciary duties." Language in an agreement that allows the partners discretion in certain areas does not metamorphose [transform] the document into an unrestricted license to engage in self-dealing at the expense of those to whom the managing partner owes such a duty. There is no authority for the proposition that there can be a priori waiver of fiduciary duties in a partnership. Nor is the practice of imposing purported advance waivers of fiduciary duties in limited partnership enterprises to be given judicial recognition. [Emphasis added.]

Here, there was ample evidence to support the [trial] court's finding of a breach of fiduciary duty, including the "cost plus fee" contract that the general partner awarded to the general contractor and the profits from condominium upgrades that went to the general contractor, not to the limited partnership. Paragraph 1.7 of the limited partnership agreement did not immunize the partners against liability for breach of fiduciary duty.

DECISION AND REMEDY • The state intermediate appellate court affirmed the lower court's judgment. A partnership agreement cannot "contract away" the fiduciary duty that a general partner owes to limited partners.

WHAT IF THE FACTS WERE DIFFERENT? • Suppose that instead of choosing Sutherland and Pearsall Development to be the general contractor, SP had selected a party with no connection to any of 1515's partners. Is it likely that the result in this case would have been different? Why or why not?

THE ETHICAL DIMENSION • Did any of the parties involved in this case commit an ethical violation? Discuss.

Dissociation and Dissolution

A general partner has the power to voluntarily dissociate, or withdraw, from a limited partnership unless the partnership agreement specifies otherwise. A limited partner theoretically can withdraw from the partnership by giving six months' notice unless the partnership agreement specifies a term, as most do. Also, some states have passed laws prohibiting the withdrawal of limited partners.

In a limited partnership, a general partner's voluntary dissociation from the firm normally will lead to dissolution *unless* all partners agree to continue the business. Similarly, the bankruptcy, retirement, death, or mental incompetence of a general partner will cause the dissociation of that partner and the dissolution of the limited partnership unless the other members agree to continue the firm [RULPA 801]. Bankruptcy of a limited partner, however, does

not dissolve the partnership unless it causes the bankruptcy of the firm. Death or an assignment of the interest of a limited partner does not dissolve a limited partnership [RULPA 702, 704, 705]. A limited partnership can be dissolved by court decree [RULPA 802].

On dissolution, creditors' claims, including those of partners who are creditors, take first priority. After that, partners and former partners receive unpaid distributions of partnership assets and, except as otherwise agreed, amounts representing returns of their contributions and amounts proportionate to their shares of the distributions [RULPA 804].

In the following case, two limited partners wanted the business of the partnership to be sold on its dissolution, while another limited partner (actor Kevin Costner) and the general partner wanted it to continue.



✱ EXTENDED CASE 37.3 ✱ In re Dissolution of Midnight Star Enterprises, LP

Supreme Court of South Dakota, 2006 SD 98, 724 N.W.2d 334 (2006).

IN THE LANGUAGE OF THE COURT



SABERS, Justice.

* * *

Midnight Star Enterprises, L.P. (Midnight Star) is a

limited partnership, which operates a gaming, on-sale liquor and restaurant business in Deadwood, South Dakota. The owners of Midnight Star consist of: Midnight Star Enterprises, Ltd. (MSEL) as the general partner, owning 22 partnership units; Kevin Costner (Costner), owning 71.50 partnership units; and Francis and Carla Canevas (Canevas), owning 3.25 partnership units each. Costner is the sole owner of MSEL and essentially owns 93.5 partnership units.

The Canevas managed the operations of Midnight Star, receiving salaries and bonuses for their employment. According to MSEL, it became concerned about the Canevas' management and voiced concerns. Communications between the * * * partners broke down * * *.

MSEL * * * brought a Petition for Dissolution [in a South Dakota state court]. In order to dissolve, the fair market value of Midnight Star had to be assessed. MSEL hired Paul Thorstenson, an accountant, to determine the fair market value. * * * The Canevas solicited an "offer" from Ken Kellar, a Deadwood casino, restaurant, and hotel owner * * *.

* * * Thorstenson determined the fair market value was \$3.1 million based on the hypothetical transaction standard of valuation. * * * The * * * court * * * found Kellar's offer of \$6.2 million to be the fair market value * * * [and] ordered the majority owners to buy the business for \$6.2 million within 10 days or the court would order the business to be sold on the open market. [MSEL appealed to the South Dakota Supreme Court.] * * *

[The] Canevas claim the partnership agreement does not allow the general partner to buy out their interest in Midnight Star. Instead,

the Canevas argue, the agreement mandates the partnership be sold on the open market upon dissolution.

* * * Article 10.4 provides:

After all of the debts of the Partnership have been paid, the General Partner * * * may distribute in kind any Partnership property provided that a good faith effort is first made to sell * * * such property * * * at its estimated fair value to one or more third parties * * *.

* * *

* * * This provision clearly states the General Partner "may distribute in kind any partnership property" if the property is first offered to a third party for a fair value. While the General Partner may offer the property on the open market, Article 10.4 does not require it.

This interpretation is reinforced when read together with Article 10.3.1 * * * [which] instructs that "no assets * * * shall be sold or otherwise transferred to [any

EXTENDED CASE 37.3 CONTINUED ♦

partner] unless the assets are valued at their then fair market value * * *." *If Article 10.4 requires a forced sale, then there would be no need to have the fair market value provision of Article 10.3.1.* [Emphasis added.]

* * * Read as a whole, the partnership agreement does not require a mandatory sale upon dissolution. Instead, the general partner can opt to liquidate using either a sale or transfer under Article 10.3.1. * * *

Because MSEL decided to pursue dissolution under Article 10.3.1, we decide the correct standard for determining the fair market value of the partnership.

* * * * *

MSEL claims the correct standard * * * is the hypothetical

transaction analysis * * *. [The] Canevas argue that * * * the offer from Kellar represented the fair market value * * *.

* * * * *

* * * [There are] sound policy reasons why an offer cannot be the fair market value. * * * What if a businessman, for personal reasons, offers 10 times the real value of the business? What if the partnership, for personal reasons, such as sentimental value, refuses to sell for that absurdly high offer? *These arbitrary, emotional offers and rejections cannot provide a rational and reasonable basis for determining the fair market value.* [Emphasis added.]

Conversely, the hypothetical transaction standard does provide a rational and reasonable basis for determining the fair market value

* * * by removing the irrationalities, strategies, and emotions * * *.

* * * * *

Since it was error for the [lower] court to value Midnight Star at \$6.2 million, it was also error to force the general partners to buy the business for \$6.2 million or sell the business.

* * * * *

* * * Instead of ordering the majority partners to purchase the whole partnership for the appraised value, the majority partners should only be required to pay any interests the withdrawing partner is due.

* * * The majority partners should only be required to pay the Canevas the value of their 6.5 partnership units * * *.

* * * We reverse and remand for further proceedings * * *.



QUESTIONS

1. Why did the court hold that a forced sale of the property of the limited partnership was not appropriate?
2. Under what circumstances might a forced sale of the property of a limited partnership on its dissolution be appropriate?

Limited Liability Limited Partnerships

A **limited liability limited partnership (LLLP)** is a type of limited partnership. An LLLP differs from a limited partnership in that a general partner in an LLLP has the same liability as a limited partner in a limited partnership. In other words, the liability of all partners is limited to the amount of their investments in the firm.

A few states provide expressly for LLLPs.¹⁷ In states that do not provide for LLLPs but do allow for limited partnerships and limited liability partnerships, a limited partnership should probably still be able to register with the state as an LLLP.

17. See, for example, Colorado Revised Statutes Annotated Section 7-62-109. Other states that provide expressly for limited liability limited partnerships include Delaware, Florida, Georgia, Kentucky, Maryland, Nevada, Texas, and Virginia.



REVIEWING

Partnerships and Limited Liability Partnerships

Grace Tarnavsky and her sons, Manny and Jason, bought a ranch known as the Cowboy Palace in March 2007, and the three verbally agreed to share the business for five years. Grace contributed 50 percent of the investment, and each son contributed 25 percent. Manny agreed to handle the livestock, and Jason agreed to handle the bookkeeping. The Tarnavskys took out joint loans and opened a joint

REVIEWING CONTINUES ♦



REVIEWING

Partnerships and Limited Liability Partnerships, Continued

bank account into which they deposited the ranch's proceeds and from which they made payments toward property, cattle, equipment, and supplies. In September 2011, Manny severely injured his back while baling hay and became permanently unable to handle livestock. Manny therefore hired additional laborers to tend the livestock, causing the Cowboy Palace to incur significant debt. In September 2012, Al's Feed Barn filed a lawsuit against Jason to collect \$32,400 in unpaid debts. Using the information presented in the chapter, answer the following questions.

1. Was this relationship a partnership for a term or a partnership at will?
2. Did Manny have the authority to hire additional laborers to work at the ranch after his injury? Why or why not?
3. Under the current UPA, can Al's Feed Barn bring an action against Jason individually for the Cowboy Palace's debt? Why or why not?
4. Suppose that after his back injury in 2011, Manny sent his mother and brother a notice indicating his intent to withdraw from the partnership. Can he still be held liable for the debt to Al's Feed Barn? Why or why not?

DEBATE THIS: *A partnership should automatically end when one partner dissociates from the firm.*



TERMS AND CONCEPTS

articles of partnership 721
buyout price 728
buy-sell agreement 729
certificate of limited partnership 731
charging order 723

confession of judgment 722
dissociation 727
dissolution 728
family limited liability partnership (FLLP) 730
general partner 731
goodwill 720
information return 721

joint and several liability 726
joint liability 726
limited liability limited partnership (LLLP) 735
limited liability partnership (LLP) 730
limited partner 731

limited partnership (LP) 731
partnership 720
partnership by estoppel 722
pass-through entity 720
winding up 728



QUESTIONS AND CASE PROBLEMS

37-1. Partnership Formation Daniel is the owner of a chain of shoe stores. He hires Rubya to be the manager of a new store, which is to open in Grand Rapids, Michigan. Daniel, by written contract, agrees to pay Rubya a monthly salary and 20 percent of the profits. Without Daniel's knowledge, Rubya represents himself to Classen as Daniel's partner and shows Classen the agreement to share profits. Classen extends credit to Rubya. Rubya defaults. Discuss whether Classen can hold Daniel liable as a partner.

37-2. QUESTION WITH SAMPLE ANSWER: Partnership Dissolution.



Dorinda, Luis, and Elizabeth form a limited partnership. Dorinda is a general partner, and Luis and Elizabeth are limited partners. Consider the separate events below, and discuss fully whether each event constitutes a dissolution of the limited partnership.

- (a) Luis assigns his partnership interest to Ashley.

- (b) Elizabeth is petitioned into involuntary bankruptcy.
- (c) Dorinda dies.

• For a sample answer to Question 37-2, go to Appendix I at the end of this text.

37-3. Distribution of Partnership Assets Meyer, Knapp, and Cavanna establish a partnership to operate a window-washing service. Meyer contributes \$10,000 to the partnership, and Knapp and Cavanna contribute \$1,000 each. The partnership agreement is silent as to how profits and losses will be shared. One month after the partnership begins operation, Knapp and Cavanna vote, over Meyer's objection, to purchase another truck for the firm. Meyer believes that because he contributed \$10,000, the partnership cannot make any major commitment to purchase over his objection. In addition, Meyer claims that in the absence of any provision in the agreement, profits must be divided in the same ratio as capital contributions. Discuss Meyer's contentions.

37-4. Indications of Partnership At least six months before the 1996 Summer Olympic Games in Atlanta, Georgia, Stafford Fontenot, Steve Turner, Mike Montelaro, Joe Sokol, and Doug Brinsmade agreed to sell Cajun food at the Games and began making preparations. Calling themselves "Prairie Cajun Seafood Catering of Louisiana," on May 19 the group applied for a license with the Fulton County, Georgia, Department of Public Health-Environmental Health Services. Later, Ted Norris received for the sale of a mobile kitchen an \$8,000 check drawn on the "Prairie Cajun Seafood Catering of Louisiana" account and two promissory notes, one for \$12,000 and the other for \$20,000. The notes, which were dated June 12, listed only Fontenot "d/b/a [doing business as] Prairie Cajun Seafood" as the maker. On July 31, Fontenot and his friends signed a partnership agreement, which listed specific percentages of profits and losses. They drove the mobile kitchen to Atlanta, but business was "disastrous." When the notes were not paid, Norris filed a suit in a Louisiana state court against Fontenot, seeking payment. What are the elements of a partnership? Did a partnership exist among Fontenot and the others? Why or why not? Who is liable on the notes? Why? [Norris v. Fontenot, 867 So.2d 179 (La.App. 3 Cir. 2004)]

37-5. Partnership Status Charlie Waugh owned and operated an auto parts junkyard in Georgia. Charlie's son, Mack, started working in the business part-time as a child and full-time when he left school at the age of sixteen. Mack oversaw the business's finances, depositing the profits in a bank. Charlie gave Mack a one-half interest in the business, telling him that if "something happened" to Charlie, the entire business would be his. In 1994, Charlie and his wife, Alene, transferred to Mack the land on which the junkyard was located. Two years later, however, Alene and her daughters, Gail and Jewel, falsely convinced Charlie, whose mental competence had deteriorated, that Mack had cheated him. Mack was ordered off the land. Shortly thereafter, Charlie died.

Mack filed a suit in a Georgia state court against the rest of the family, asserting, in part, that he and Charlie had been partners and that he was entitled to Charlie's share of the business. Was the relationship between Charlie and Mack a partnership? Is Mack entitled to Charlie's "share"? Explain. [Waugh v. Waugh, 265 Ga.App. 799, 595 S.E.2d 647 (2004)]

37-6. CASE PROBLEM WITH SAMPLE ANSWER: Indications of Partnership.



In August 2003, Tammy Duncan began working as a waitress at Bynum's Diner, which was owned by her mother, Hazel Bynum, and her stepfather, Eddie Bynum, in Valdosta, Georgia. Less than a month later, the three signed an agreement under which Eddie was to relinquish his management responsibilities, allowing Tammy to be co-manager. At the end of this six-month period, Eddie would revisit this agreement and could then extend it for another six-month period. The diner's bank account was to remain in Eddie's name. There was no provision with regard to the diner's profit, if any, and the parties did not change the business's tax information. Tammy began doing the bookkeeping, as well as waiting tables and performing other duties. On October 30, she slipped off a ladder and injured her knees. At the end of the six-month term, Tammy quit working at the diner. The Georgia State Board of Workers' Compensation determined that she had been the diner's employee and awarded her benefits under the diner's workers' compensation policy with Cypress Insurance Co. Cypress filed a suit in a Georgia state court against Tammy, arguing that she was not an employee, but a co-owner. What are the essential elements of a partnership? Was Tammy a partner in the business of the diner? Explain. [Cypress Insurance Co. v. Duncan, 281 Ga.App. 469, 636 S.E.2d 159 (2006)]

- To view a sample answer for Problem 37-6, go to this book's Web site at www.cengage.com/blaw/clarkson, select "Chapter 37," and click on "Case Problem with Sample Answer."

37-7. Partnership Dissolution Nine minority partners each owned one-half of 1 percent of J&J Celcom, a partnership with AT&T, which owned the rest. AT&T, using its majority power, voted to buy out the minority partners. It offered each partner a price that was slightly higher than the price provided by a third party's appraisal. Some of the partners accepted the offer, but others did not. AT&T then voted to dissolve the partnership, forcing the remaining minority partners to accept the appraisal price. Those partners sued. The trial court held for AT&T, and the minority partners appealed. The appeals court held that the price offered was the fair market price, but certified the following question to Washington State's highest court: "Does a controlling partner violate the duty of loyalty to the partnership or to dissenting minority partners where the controlling partner causes the partnership to sell all its assets" to another party? How should the Washington Supreme Court answer this question? Why? [J&J Celcom v. AT&T Wireless Services, Inc., 162 Wash.2d 102, 169 P.3d 823 (Sup.Ct. 2007)]

37-8. Limited Partnership James Carpenter contracted with Austin Estates, LP, to buy property in Texas. Carpenter asked Sandra McBeth to invest in the deal. He admitted that a dispute had arisen with the city of Austin over water for the property, but he assured her that it would not be a significant obstacle. McBeth agreed to invest \$800,000 to hold open the option to buy the property. She became a limited partner in StoneLake Ranch, LP. Carpenter acted as the firm's general partner. Despite his assurances to McBeth, the purchase was delayed due to the water dispute. Unable to complete the purchase in a timely manner, Carpenter paid the \$800,000 to Austin Estates without notifying McBeth. Later, Carpenter and others—excluding McBeth—bought the property and sold it at a profit. McBeth filed a suit in a Texas state court against Carpenter. What is the nature of the fiduciary duty that a general partner owes a limited partner? Did Carpenter breach that duty in this case? Explain. [McBeth v. Carpenter, 565 F.3d 171 (5th Cir. 2009)]

37-9. Partnership Dissolution George Chaney and William Dickerson were partners in Bowen's Mill Landing, which purchased a large piece of land in the 1980s. The partners had planned to develop the property, but nothing was ever done. Chaney died in 1990, and his wife inherited his interest. When she died in 2004, her two sons, John and Dewey Lynch, inherited the half-interest in the partnership. Dickerson died in 1995, and his daughter, Billie Thompson, inherited his half-interest. In 2006, the Lynches filed a petition for partition, asking that a commission be appointed to make a fair division of the land, giving the Lynches half and Thompson half. In 2007, the commission reported on how to divide the land into two parts. Thompson objected that the land belonged to Bowen's Mill Landing and could not be divided. The trial court ordered Thompson to "effectuate the dissolution of any partnership entity and . . . to wind up the business and affairs of any partnership" so that the land could be divided. Thompson appealed. Can the court order the partnership to dissolve? Why or why not? [Thompson v. Lynch, 990 A.2d 432 (Sup.Ct.Del. 2010)]

37-10. A QUESTION OF ETHICS: Wrongful Dissociation.



Elliot Willensky and Beverly Moran formed a partnership to renovate and "flip" (resell) some property. According to their agreement, Moran would finance the purchase and renovation of the property, and

Willensky would provide labor and oversight of the renovation work. Moran would be reimbursed from the profits of the sale, and the remainder of the profits would be divided evenly. Any losses would also be divided evenly. Moran paid \$240,000 for a house and planned to spend \$60,000 for its renovation. The parties agreed that the renovation would be completed in six months. Willensky lived in the house during the renovation. More than a year later, the project still was not completed, and the cost was much more than the \$60,000 originally planned. Willensky often failed to communicate with Moran, and when she learned that her funds were nearly exhausted and the house nowhere near completion, she became worried. She told Willensky that he would have to pay rent and utility bills if he wished to continue to live in the house. Shortly thereafter, Willensky left for Florida due to a family emergency, saying that he would return as soon as he could. He never returned, however, and Moran lost touch with him. Moran took over the project and discovered that Willensky had left numerous bills unpaid, spent money on excessive or unnecessary items, and misappropriated funds for his personal use. After completing the project, paying all expenses relating to the renovation (in all, the renovation costs came to \$311,222), and selling the property, Moran brought an action in a Tennessee state court to dissolve the partnership and to recover damages from Willensky for breach of contract and wrongful dissociation from the partnership. [Moran v. Willensky, ___ S.W.3d ___ (Tenn.Ct.App. 2010)]

- (a) Moran alleged that Willensky had wrongfully dissociated from the partnership. When did this dissociation occur? Why was his dissociation wrongful?
- (b) Which of Willensky's actions simply represent unethical behavior or bad management, and which constitute a breach of the agreement?



LEGAL RESEARCH EXERCISES ON THE WEB

Go to this text's Web site at www.cengage.com/blaw/clarkson, select "Chapter 37," and click on "Practical Internet Exercises." There you will find the following Internet research exercises that you can perform to learn more about the topics covered in this chapter.

Practical Internet Exercise 37-1: Legal Perspective

Liability of Dissociated Partners

Practical Internet Exercise 37-2: Economic Perspective

Taxation of Partnerships

Practical Internet Exercise 37-3: Management Perspective

Limited Partnerships and Limited Liability Partnerships

CHAPTER 38

Limited Liability Companies and Special Business Forms



In the preceding chapters, we examined sole proprietorships, partnerships, and several forms of limited partnerships. Here, we examine a relatively new form of business organization called the *limited liability company (LLC)*. LLCs are becoming an organizational form of choice among businesspersons—

a trend encouraged by state statutes permitting their use.

In this chapter, we begin by examining the origins and evolution of the LLC. We then look at important characteristics of the LLC, including formation, jurisdictional requirements, and the advantages and disadvantages

of choosing to do business as an LLC. Next, we examine the operation and management options in an LLC. The chapter concludes with a discussion of various other special business forms, including joint ventures, syndicates, joint stock companies, business trusts, and cooperatives.

SECTION 1

THE LIMITED LIABILITY COMPANY

A **limited liability company (LLC)** is a hybrid form that combines the limited liability aspects of the corporation and the tax advantages of a partnership. These business forms are governed by state LLC statutes. These laws vary, of course, from state to state. In an attempt to create more uniformity among the states in this respect, in 1995 the National Conference of Commissioners on Uniform State Laws issued the Uniform Limited Liability Company Act (ULLCA), but less than one-fifth of the states adopted it. Some provisions are common to most state statutes, however, and we base our discussion of LLCs in this section on these common elements.

In 1977, Wyoming became the first state to pass legislation authorizing the creation of an LLC. Although LLCs emerged in the United States in the latter half of the 1900s, they have been used for more than a century in other foreign jurisdictions, including several European and South American nations. For example, the South American *limitada* is a form of business organization that operates

more or less as a partnership but provides limited liability for the owners. Japan has the *godo kaisha*, a limited liability type of business organization that is similar to an LLC.

Taxation of the LLC

In the United States, after Wyoming's adoption of an LLC statute, it still was unclear how the Internal Revenue Service (IRS) would treat the LLC for tax purposes. In 1988, however, the IRS ruled that Wyoming LLCs would be taxed as partnerships instead of corporations, providing that certain requirements were met. Before this ruling, only one additional state—Florida, in 1982—had authorized LLCs. The 1988 ruling encouraged other states to enact LLC statutes, and in less than a decade, all states had done so.

In 1997, IRS rules also encouraged more widespread use of LLCs in the business world. Under these rules, any unincorporated business with more than one owner is automatically taxed as a partnership unless it indicates otherwise on its tax form or fits into one of the exceptions. The exceptions involve publicly traded companies, companies formed under a state incorporation statute, and certain foreign-owned companies. If a business chooses

to be taxed as a corporation, it can indicate this preference by checking a box on its tax form.

Part of the impetus behind creating LLCs in this country is that foreign investors are allowed to become LLC members. Thus, in an era increasingly characterized by global business efforts and investments, the LLC offers U.S. firms and potential investors from other countries flexibility and the opportunity for limited liability and increased tax benefits.

The Nature of the LLC

LLCs share many characteristics with corporations. Like corporations, LLCs are creatures of state statute. In other words, they must be formed and operated in compliance with state law. Like the shareholders of a corporation, the owners of an LLC, who are called **members**, enjoy limited liability [ULLCA 303].¹ Thus, if the LLC is sued for wrongful discharge, for example, its individual members, managers, and agents cannot be held liable based solely on their status in the LLC.²

Similar to corporations, LLCs are legal entities apart from their owners. As a legal person, the LLC can sue or be sued, enter into contracts, and hold title to property [ULLCA 201]. The terminology used to describe LLCs formed in other states or nations is also similar to that used in corporate law. For example, an LLC formed in one state but doing business in another state is referred to in the second state as a *foreign LLC*.

1. Members of an LLC can also bring derivative actions, which you will read about in Chapter 40, on behalf of the LLC [ULLCA 101]. As with a corporate shareholder's derivative suit, any damages recovered go to the LLC, not to the members personally.
2. See, for example, *McFarland v. Virginia Retirement Services of Chesterfield, LLC*, 477 F.Supp.2d 727 (2007).

The Formation of the LLC

As mentioned, LLCs are creatures of statute and thus must follow state statutory requirements. To form an LLC, **articles of organization** must be filed with a central state agency—usually the secretary of state's office [ULLCA 202].³ Typically, the articles are required to include such information as the name of the business, its principal address, the name and address of a registered agent, the names of the owners, and information on how the LLC will be managed [ULLCA 203]. The business's name must include the words *Limited Liability Company* or the initials *LLC* [ULLCA 105(a)]. Although a majority of the states permit one-member LLCs, some states require at least two members.

Businesspersons sometimes enter into contracts on behalf of a business organization that is not yet formed. As you will read in Chapter 39, persons who are forming a corporation may enter into contracts during the process of incorporation but before the corporation becomes a legal entity. These contracts are referred to as *preincorporation contracts*. Once the corporation is formed and adopts the preincorporation contracts (by means of a *novation*, discussed in Chapter 17), it can enforce the contract terms.

In the following case, the question was whether the same principle extends to LLCs. A person in the process of forming an LLC entered into a preorganization contract under which it would be obligated to purchase a hotel. Once the LLC legally existed, the owners of the hotel refused to sell the property to the LLC, claiming that the contract was unenforceable.

3. In addition to requiring articles of organization to be filed, a few states require that a notice of the intention to form an LLC be published in a local newspaper.



CASE 38.1

02 Development, LLC v. 607 South Park, LLC

Court of Appeal of California, Second District, 159 Cal.App.4th 609, 71 Cal.Rptr.3d 608 (2008).

BACKGROUND AND FACTS • In 2004, 607 South Park, LLC, entered into a written agreement to sell Park Plaza Hotel to 607 Park View Associates, Ltd., for \$8.7 million. The general partner of 607 Park View Associates was Creative Environments of Hollywood, Inc. In 2005, Creative Environments assigned the rights to the hotel purchase to another company, 02 Development, LLC. At the time, 02 Development did not yet exist; it was legally created several months later. When 607 South Park subsequently refused to sell the hotel, 02 Development sued 607 South Park for breach of the hotel purchase agreement. 607 South Park moved for summary judgment, arguing that no enforceable contract

CASE 38.1 CONTINUED ♦ existed because at the time of the assignment, 02 Development did not yet legally exist. Furthermore, 607 South Park argued that 02 Development suffered no damages because it was “not ready, willing, and able to fund the purchase of the hotel.” The trial court granted the motion and entered judgment in favor of 607 South Park. 02 Development appealed.



IN THE LANGUAGE OF THE COURT

ROTHSCHILD, J. [Judge]

* * *

It is hornbook law [black letter, or well-established, law] that a corporation can enforce preincorporation contracts made in its behalf, as long as the corporation “has adopted the contract or otherwise succeeded to it.” * * * California law does not deviate from that well-established norm. *607 South Park does not argue that limited liability companies should be treated differently from corporations in this respect, and we are aware of no authority that would support such a position.* 607 South Park’s first ground for its summary judgment motion—that there is no enforceable contract between 607 South Park and 02 Development because 02 Development did not exist when the assignment agreement was executed—therefore fails as a matter of law. [Emphasis added.]

607 South Park’s principal contention to the contrary is that a nonexistent business entity cannot be a party to a contract. The contention is true but irrelevant. *When the assignment agreement was executed, 02 Development did not exist, so it was not then a party to the agreement. But once 02 Development came into existence, it could enforce any pre-organization contract made in its behalf, such as the assignment agreement, if it adopted or ratified it.* [Emphasis added.]

* * *

In the trial court, 607 South Park contended that in order to prove causation, 02 Development would have to prove either that it had the \$8.7 million necessary to fund the transaction or that it had legally binding commitments from third parties to provide the necessary funding. * * * 607 South Park disavows [this contention] on appeal.

Instead, 607 South Park now argues that its motion was based on the proposition that 02 Development “must present admissible evidence that it would have been financially able to close the transaction.” But 607 South Park’s evidence in support of its motion showed only that 02 Development had neither the \$8.7 million to fund the transaction nor legally binding commitments from third parties to provide the funding. *607 South Park presented no evidence that 02 Development would have been unable to arrange for the necessary funding to close the transaction on time if 607 South Park had given it the opportunity instead of repudiating the contract in advance.* Because 607 South Park introduced no evidence to support an argument based on the proposition of law that 607 South Park is now advocating, the burden of production never shifted to 02 Development to present contrary evidence. For all of these reasons, the trial court erred when it granted 607 South Park’s motion for summary judgment. [Emphasis added.]

DECISION AND REMEDY • The California intermediate appellate court reversed the judgment and directed the trial court to enter an order denying 607 South Park’s motion for summary judgment. According to the appellate court, limited liability companies should be treated the same as corporations with respect to preorganization contracts.

THE LEGAL ENVIRONMENT DIMENSION • Why did the appellate court dismiss 607 South Park’s argument that 02 Development should be required to prove that it had funding commitments for \$8.7 million?

THE ETHICAL DIMENSION • What might have been some of the reasons that 607 South Park refused to sell the property to 02 Development?

Jurisdictional Requirements

One of the significant differences between LLCs and corporations involves federal jurisdictional requirements. Under the federal jurisdiction statute, a

corporation is deemed to be a citizen of the state where it is incorporated and maintains its principal place of business. The statute does not mention the state citizenship of partnerships, LLCs, and other

unincorporated associations, but the courts have tended to regard these entities as citizens of every state in which their members are citizens.

The state citizenship of an LLC may come into play when a party sues the LLC based on diversity of citizenship. Remember from Chapter 2 that when parties to a lawsuit are from different states and the amount in controversy exceeds \$75,000, a federal court can exercise diversity jurisdiction. *Total* diversity of citizenship must exist, however.

Suppose that Jen Fong, a citizen of New York, wishes to bring a suit against Skycel, an LLC formed under the laws of Connecticut. One of Skycel's members also lives in New York. Fong will not be able to bring a suit against Skycel in federal court on the basis of diversity jurisdiction because the defendant LLC is also a citizen of New York. The same would be true if Fong was bringing a suit against multiple defendants and one of the defendants lived in New York.

Advantages of the LLC

The LLC offers many advantages to businesspersons, which is why this form of business organization has become increasingly popular.

LIMITED LIABILITY A key advantage of the LLC is that the liability of members is limited to the amount of their investments. Although the LLC as an entity can be held liable for any loss or injury caused by the wrongful acts or omissions of its members, the members themselves generally are not personally liable.

As you will read in Chapter 39, the courts on occasion make an exception to the limited liability of shareholders. In certain circumstances, a court will *pierce the corporate veil* and hold a shareholder personally liable for a corporate obligation.

Sometimes, the corporate veil is pierced when a corporation is deemed to be merely an "alter ego" of the shareholder-owner (see page 768). A court may apply the alter-ego theory when a shareholder commingles personal and corporate funds or fails to observe required corporate formalities.

Whether the alter-ego theory should be applied to an LLC was at issue in the following case.



EXTENDED CASE 38.2 ORX Resources, Inc. v. MBW Exploration, LLC

Court of Appeal of Louisiana, Fourth Circuit, 32 So.3d 931 (2010).
www.la4th.org

IN THE LANGUAGE OF THE COURT

Charles R. JONES, Judge.



On January 16, 2003, ORX [Resources, Inc.] entered into the "Clovelly Purchase Agreement" with Coastline Oil & Gas, Inc. Pursuant to this Agreement, ORX purchased certain oil, gas and mineral leases/interests in a tract of land located in Lafourche Parish, known as the "Clovelly Prospect." ORX partnered with other entities, including MBW [Exploration, LLC], to share in the expense and potential profits of the

venture to explore and develop the Clovelly Prospect. The partnering parties entered into a Joint Operating Agreement ("JOA") and the Clovelly Prospect Participation Agreement ("Participation Agreement"). Mr. [Mark] Washauer signed these documents in October of 2003 and December of 2004, respectively, on behalf of MBW, in his capacity as a "Managing Member." However, MBW did not come into existence until July of 2005, when its articles of organization were filed with the Louisiana Secretary of State.

The JOA provided that ORX was to serve as the "Operator" drilling a

well within the Clovelly Prospect. It further provided that the nonoperating working interest partners, like MBW, would pay their proportionate share of the costs in exchange for a corresponding working interest ownership share in the Clovelly Prospect. The drilled well was governed by the Participation Agreement, which provided that MBW had a working interest in the Clovelly Prospect whereby MBW would share in 2.5% of the costs incurred, and would gain a proportionate share of the returns, if any, produced by the well.

Later, ORX submitted an Authorization for Expenditure

a. In the "Case Searching Options" area of the screen, select "Opinions." When the search page opens, select "Search Case Year and Number" and then enter "2009" in the "Case Year" box and "0662" in the "Case Number" box. When the search result appears at the bottom of the screen, click on "Download Opinion." The Louisiana Court of Appeal for the Fourth Circuit maintains this Web site.

EXTENDED CASE 38.2 CONTINUED ♦

("AFE") to MBW for approval, which Mr. Washauer signed in his own name. Additionally, he paid MBW's participation fee with a check drawn from the account of another entity, MBW Properties, LLC.

In 2006, ORX, as the well Operator, began planning the Allain LeBreton Well No. 2 in the Clovelly Prospect, ("the Well"), which was the "initial well" called for in the Participation Agreement. * * * Mr. Washauer paid the full amount of MBW's share of an ORX cash call invoice of \$59,325 with a personal check.

The well proved to be unsuccessful, and was ultimately plugged. MBW's unpaid share of expenses for said project amounted to \$84,220.01, for which ORX demanded payment via correspondence, but to no avail. As a result, ORX filed suit for breach of contract against both MBW and Mr. Washauer ("the Appellants").

* * * [The trial court—a state district court—determined that Washauer operated MBW as his alter ego and allowed ORX to pierce the veil of the LLC. The court granted summary judgment in favor of ORX, holding that Washauer and MBW were liable, jointly and severally, to ORX in the amount of \$84,220.01.]

The Appellants timely filed [an] appeal from this judgment.

* * * *

We first address whether the district court erred in ruling that the alter ego theory of the corporate veil piercing applied to Louisiana limited liability companies.

* * * *

The provisions of La. R.S. [Louisiana Revised Statutes] 12:1320(D) provide for the piercing of an LLC's veil when the situation so warrants.

* * * *

* * * *Piercing the veil of an LLC is justified to prevent the use of the LLC form to defraud creditors.* Under our * * * review, we find that the district court did not err in determining that the alter ego theory of corporate veil piercing applies to a Louisiana limited liability company, under the facts of this case, where it appears that Mr. Washauer used MBW as a shell and tried to avoid paying a legitimate debt of the LLC. [Emphasis added.]

* * * *

The Louisiana Supreme Court has identified *five nonexclusive factors to be used in determining whether to apply the alter ego doctrine: [commingling of corporate and shareholder funds; failure to follow statutory formalities for incorporating and transacting corporate affairs;*

undercapitalization; failure to provide separate bank accounts and bookkeeping records; and failure to hold regular shareholder and director meetings].

[Emphasis added.]

* * * *

In applying [these] factors, * * * we find that Mr. Washauer's activities on behalf of MBW do merit the piercing of the veil of this LLC. Commingling of the LLC's funds occurred with the funds of Mr. Washauer and a separate company of his. This commingling occurred because MBW was undercapitalized and did not have a separate bank account to transact its own affairs. Furthermore, at the time MBW began contracting with ORX, it was not yet recognized as an LLC by the Louisiana Secretary of State. Lastly, while LLCs are not bound by corporate laws to hold regular meetings, the fact that MBW has not had a meeting in over a year further evidences that Mr. Washauer was operating MBW at his leisure and direction. Thus, we find that the district court did not err in determining that MBW was being operated as the alter ego of Mr. Washauer under the [above-mentioned] factors, and therefore, he can be held personally liable jointly and solidarily [severally] with MBW.

For the foregoing reasons, * * * the judgment of the district court is affirmed * * * .



QUESTIONS

1. One of the advantages of the LLC is that its members enjoy limited personal liability for the company's obligations. In view of this fact, does the possibility that a court may hold an LLC member personally liable for the LLC's debts reduce the utility of the LLC form of business organization? Explain.
2. What does "jointly and solidarily" (jointly and severally) mean in terms of liability? Would ORX prefer that Washauer and MBW be held personally liable jointly and severally, rather than that Washauer alone be held personally liable? Explain.

FLEXIBILITY IN TAXATION Another advantage of the LLC is its flexibility in regard to taxation. An LLC that has *two or more members* can choose to be taxed as either a partnership or a corporation. As will be discussed in Chapter 39, a corporate entity must pay income taxes on its profits, and the shareholders pay personal income taxes on profits distributed as

dividends. An LLC that wants to distribute profits to its members may prefer to be taxed as a partnership to avoid the "double taxation" that is characteristic of the corporate entity.

Unless an LLC indicates that it wishes to be taxed as a corporation, the IRS automatically taxes it as a partnership. This means that the LLC, as an entity,

pays no taxes. Rather, as in a partnership, profits are “passed through” the LLC to the members, who then personally pay taxes on the profits. If an LLC’s members want to reinvest profits in the business rather than distribute the profits to members, however, they may prefer to be taxed as a corporation. Corporate income tax rates may be lower than personal tax rates. Part of the attractiveness of the LLC is this flexibility with respect to taxation.

An LLC that has only *one member* cannot be taxed as a partnership. For federal income tax purposes, one-member LLCs are automatically taxed as sole proprietorships unless they indicate that they wish to be taxed as corporations. With respect to state taxes, most states follow the IRS rules.

MANAGEMENT AND FOREIGN INVESTORS Another advantage of the LLC for businesspersons is the flexibility it offers in terms of business operations and management—as will be discussed shortly. Because foreign investors can participate in an LLC, the LLC form of business is attractive as a way to encourage investment.

Disadvantages of the LLC

The main disadvantage of the LLC is that state LLC statutes are not uniform. Therefore, businesses that operate in more than one state may not receive consistent treatment in these states. Generally, most states apply to a foreign LLC (an LLC formed in another state) the law of the state where the LLC was formed. Nonetheless, difficulties can arise when one state’s court must interpret and apply another state’s laws.

SECTION 2 OPERATION AND MANAGEMENT OF AN LLC

As mentioned, an advantage of the LLC form of business is the flexibility it offers in terms of operation and management. Here, we discuss the operating agreement, management options, and general operating procedures of LLCs.

The LLC Operating Agreement

The members of an LLC can decide how to operate the various aspects of the business by forming an **operating agreement** [ULLCA 103(a)]. Operating agreements typically contain provisions relating to management, how profits will be divided, the

transfer of membership interests, whether the LLC will be dissolved on the death or departure of a member, and other important issues.

A WRITING IS PREFERRED In many states, an operating agreement is not required for an LLC to exist, and if there is one, it need not be in writing. Generally, though, LLC members should protect their interests by creating a written operating agreement. As with any business, disputes may arise over any number of issues. If there is no agreement covering the topic under dispute, such as how profits will be divided, the state LLC statute will govern the outcome. For example, most LLC statutes provide that if the members have not specified how profits will be divided, they will be divided equally among the members.

PARTNERSHIP LAW MAY APPLY When an issue, such as the authority of individual members, is not covered by an operating agreement or by an LLC statute, the courts often apply principles of partnership law. These principles can give the members broad authority to bind the LLC unless the operating agreement provides otherwise.

CASE IN POINT Clifford Kuhn, Jr., and Joseph Tumminelli formed Touch of Class Limousine Service as an LLC. They did not create a written operating agreement but orally agreed that Kuhn would provide the financial backing and that Tumminelli would manage the day-to-day operations. Tumminelli embezzled \$283,000 from the company after cashing customers’ checks at Quick Cash, Inc., a local check-cashing service. Kuhn sued Tumminelli and Quick Cash to recover the embezzled funds. He argued that Quick Cash was liable because Tumminelli did not have the authority to cash the company’s checks. The court, however, held that in the absence of a written operating agreement to the contrary, a member of an LLC, like a partner in a partnership, has the authority to cash a firm’s checks.⁴

Management of an LLC

Basically, LLC members have two options for managing the firm. It can be either a “member-managed” LLC or a “manager-managed” LLC. Most state LLC statutes and the ULLCA provide that unless the articles of organization specify otherwise, an LLC is assumed to be member managed [ULLCA 203(a)(6)].

In a *member-managed* LLC, all of the members participate in management, and decisions are made by majority vote [ULLCA 404(a)]. In a *manager-managed*

4. *Kuhn v. Tumminelli*, 366 N.J. Super. 431, 841 A.2d 496 (2004).

LLC, the members designate a group of persons to manage the firm. The management group may consist of only members, both members and nonmembers, or only nonmembers.

Under the ULLCA, managers in a manager-managed LLC owe fiduciary duties (the duty of loyalty and the duty of care) to the LLC and its members—just as corporate directors and officers owe fiduciary duties to the corporation and its shareholders [ULLCA 409(a), 409(h)]. But because not all states have adopted the ULLCA, some state statutes provide that managers owe fiduciary duties only to the LLC and not to the LLC's members. Although to whom the duty is owed may seem insignificant at first glance, it can have a dramatic effect on the outcome of litigation. See this chapter's *Insight into Ethics* feature below for further discussion of this issue.

Operating Procedures

An LLC's operating agreement can also include provisions governing decision-making procedures. For instance, the agreement can set forth procedures for choosing or removing managers. Although most LLC statutes are silent on this issue, the ULLCA provides that members may choose and remove managers by majority vote [ULLCA 404(b)(3)].

The members are also free to include in the agreement provisions designating when and for what purposes they will hold formal members' meetings. Most state LLC statutes have no provisions regarding members' meetings, which is in contrast to most state laws governing corporations, as you will read in Chapter 39.

Members may also specify in their agreement how voting rights will be apportioned. If they do not, LLC statutes in most states provide that voting rights are apportioned according to each member's capital contributions.⁵ Some states provide that, in the absence of an agreement to the contrary, each member has one vote.

SECTION 3

DISSOCIATION AND DISSOLUTION OF AN LLC

Recall from Chapter 37 that in the context of partnerships, *dissociation* occurs when a partner ceases to be associated in the carrying on of the partnership business. The same concept applies to LLCs. A member

5. In contrast, partners in a partnership generally have equal rights in management and equal voting rights unless they specify otherwise in their partnership agreement (see Chapter 37).



INSIGHT INTO ETHICS Fiduciary Duties of LLC Managers

Fiduciary duties, such as the duty of loyalty and the duty of care, have an ethical component because they require a person to act honestly and faithfully toward another. In states that have adopted the ULLCA, the managers of a manager-managed LLC owe fiduciary duties to the members and thus basically are required to behave ethically toward them. In other states, however, the LLC statutes may not include such a requirement. Consequently, even when a manager has acted unfairly and unethically toward members, the members may not be able to sue the manager for a breach of fiduciary duties.

In North Carolina and Virginia, for example, the LLC statutes do not explicitly create fiduciary duties for managers to members. Instead, the statutes require that a manager exercise good business judgment in the best interests of the company. Because the statutes are silent on the manager's duty to members, in 2009 courts in those two states held that a manager-member owed fiduciary duties only to the LLC and

not to the other members.^a In contrast, in two other cases decided in 2009, courts in Idaho and Kentucky held that a manager-member owed fiduciary duties to the LLC's other members and that the members could sue the manager for breaching fiduciary duties.^b

CRITICAL THINKING

INSIGHT INTO THE ETHICAL ENVIRONMENT

Why wouldn't a manager always owe a fiduciary duty to the members of an LLC?

a. *Remora Investments, LLC v. Orr*, 277 Va. 316, 673 S.E.2d 845 (2009), applying Virginia Code Sections 13.1-1024.1; and *Kaplan v. O.K. Technologies, LLC*, 675 S.E.2d 133 (N.C.App. 2009), applying North Carolina General Statutes Section 57C-3-22(b).
b. *Bushi v. Sage Health Care, LLC*, 146 Idaho 764, 203 P.3d 694 (2009), applying Idaho Code Sections 30-6-101 *et seq.*; and *Patmon v. Hobbs*, 280 S.W.3d 589 (Ky.App. 2009), applying Kentucky Revised Statutes Section 275.170.

of an LLC has the *power* to dissociate from the LLC at any time, but he or she may not have the *right* to dissociate. Under the ULLCA, the events that trigger a member's dissociation from an LLC are similar to the events causing a partner to be dissociated under the Uniform Partnership Act (UPA). These include voluntary withdrawal, expulsion by other members or by court order, bankruptcy, incompetence, and death. Generally, even if a member dies or otherwise dissociates from an LLC, the other members may continue to carry on the LLC business, unless the operating agreement provides otherwise.

Effect of Dissociation

When a member dissociates from an LLC, he or she loses the right to participate in management and the right to act as an agent for the LLC. The member's duty of loyalty to the LLC also terminates, and the duty of care continues only with respect to events that occurred before dissociation. Generally, the dissociated member also has a right to have his or her interest in the LLC bought out by the other members. The LLC's operating agreement may contain provisions establishing a buyout price, but if it does not, the member's interest is usually purchased at a fair value. In states that have adopted the ULLCA, the LLC must purchase the interest at fair value within 120 days after the dissociation.

If the member's dissociation violates the LLC's operating agreement, it is considered legally wrongful, and the dissociated member can be held liable for damages caused by the dissociation. Suppose that Chadwick and Barrow are members in an LLC. Chadwick manages the accounts, and Barrow, who has many connections in the community and is a skilled investor, brings in the business. If Barrow wrongfully dissociates from the LLC, the LLC's business will suffer, and Chadwick can hold Barrow liable for the loss of business resulting from her withdrawal.

Dissolution

Regardless of whether a member's dissociation was wrongful or rightful, normally the dissociated member has no right to force the LLC to dissolve. The remaining members can opt either to continue or to dissolve the business. Members can also stipulate in their operating agreement that certain events will cause dissolution, or they can agree that they have the power to dissolve the LLC by vote. As with partnerships, a court can order an LLC to be dissolved in certain circumstances, such as when the

members have engaged in illegal or oppressive conduct, or when it is no longer feasible to carry on the business.

When an LLC is dissolved, any members who did not wrongfully dissociate may participate in the winding up process. To wind up the business, members must collect, liquidate, and distribute the LLC's assets. Members may preserve the assets for a reasonable time to optimize their return, and they continue to have the authority to perform reasonable acts in conjunction with winding up. In other words, the LLC will be bound by the reasonable acts of its members during the winding up process. Once all of the LLC's assets have been sold, the proceeds are distributed to pay off debts to creditors first (including debts owed to members who are creditors of the LLC). The members' capital contributions are returned next, and any remaining amounts are then distributed to members in equal shares or according to their operating agreement.

SECTION 4 SPECIAL BUSINESS FORMS

In addition to the LLC and the other traditional business forms discussed in this unit, several other forms can be used to organize a business. For the most part, these special business forms are hybrid organizations—that is, they have characteristics similar to those of partnerships or corporations, or combine features of both. These forms include joint ventures, syndicates, joint stock companies, business trusts, and cooperatives.

Joint Venture

A **joint venture** is a relationship in which two or more persons or business entities combine their efforts or their property for a single transaction or project or a related series of transactions or projects. Unless otherwise agreed, joint venturers share profits and losses equally and have an equal voice in controlling the project. For instance, when several contractors combine their resources to build and sell houses in a single development, their relationship is a joint venture.

Joint ventures range in size from very small activities to multimillion-dollar joint actions carried out by some of the world's largest corporations. Large organizations often undertake new products or services by forming joint ventures with other enterprises. For example, Intel Corporation and Micron Technology,

Inc., formed a joint venture to manufacture NAND flash memory, a data-storage chip widely used in digital cameras, cell phones, and portable music players, including some iPods made by Apple, Inc. Similarly, Mitsubishi Chemical Corporation formed a joint venture with Exxon Chemical Corporation to start Mytex Polymers, a company that produces certain plastic compounds used by automakers in the United States and Japan.

SIMILARITIES TO PARTNERSHIPS The joint venture resembles a partnership and is taxed like a partnership. For this reason, most courts apply the same principles to joint ventures as they apply to partnerships. Joint venturers owe each other the same fiduciary duties, including the duty of loyalty, that partners owe each other. Thus, if one of the venturers secretly buys land that was to be acquired by

the joint venture, the other joint venturers may be awarded damages for the breach of loyalty. A joint venturer can also be held personally liable for the venture's debts (because joint venturers share profits and losses).

Like partners, joint venturers have equal rights to manage the activities of the enterprise, but they can agree to give control of the operation to one of the members.⁶ Joint venturers also have authority as agents to enter into contracts for the business that will bind the joint venture.

The question in the following case was whether two vintage aircraft makers had formed a joint venture.

6. See, for example, *PGI, Inc. v. Rathe Productions, Inc.*, 265 Va. 438, 576 S.E.2d 438 (2003).



CASE 38.3

SPW Associates, LLP v. Anderson

Supreme Court of North Dakota, 2006 ND 159, 718 N.W.2d 580 (2006).
www.ndcourts.com/search/opinions.asp^a

BACKGROUND AND FACTS • In 1996, Murdo Cameron and Douglas Anderson entered into a written agreement to build two vintage airplanes. Cameron was to provide an engine for the first airplane and various other component parts for both airplanes, and Anderson was to design and manufacture additional parts and build the airplanes. On the first flight of one of the planes, Anderson was to pay Cameron for the engine, with the price dependent upon the amount of time it took Anderson to build the airplane. Although not expressly stated in the written agreement, Cameron and Anderson had agreed that each would keep one of the two completed airplanes. The parties intended to build additional planes for sale to the public. In 1997, Anderson entered into a loan agreement with SPW Associates, LLP, to finance the operation. The first airplane was pledged as security for the loan. Anderson did not disclose to SPW his agreement with Cameron and did not disclose to Cameron the loan transaction with SPW. The second airplane was never built. In 2002, after Anderson defaulted on the loan, SPW brought an action against Anderson, Cameron, and others in a North Dakota state court, seeking a declaratory judgment that it was entitled to possession of the aircraft. The court found that Anderson and Cameron had entered into a joint venture and that Anderson was authorized to grant SPW a security interest in the airplane, which was joint-venture property. The court found that SPW had a perfected security interest in the airplane superior to any rights of Cameron and was entitled to possession of the plane. Cameron appealed, claiming that there was no joint venture.



IN THE LANGUAGE OF THE COURT

VANDEWALLE, Chief Justice.

* * * A joint venture is generally considered akin to a partnership, although more limited in scope and duration, and principles of partnership law apply to the joint venture relationship. [Emphasis added.]

[North Dakota Century Code] Section 45-15-01(1) * * * provides that a partner is an agent of, and may bind, the partnership * * *.

a. In the "Title:" box, type "SPW" and click on "Execute." In the result, click on the name of the case to access the opinion. The North Dakota Supreme Court maintains this Web site.

CASE CONTINUES ♦

CASE 38.3 CONTINUED ♦

* * * Applying these principles in this case, if Anderson was a joint venturer with Cameron, he had the authority to grant a security interest in joint venture property and the security agreement would be valid.

For a business enterprise to constitute a joint venture, the following four elements must be present:

- (1) contribution by the parties of money, property, time, or skill in some common undertaking * * * ; (2) a proprietary interest and right of mutual control over the engaged property; (3) an express or implied agreement for the sharing of profits * * * ; and (4) an express or implied contract showing a joint venture was formed.

* * * *

In this case there is no dispute on three of the four elements. Both parties made contributions to the enterprise, both exerted a degree of control over the enterprise, and there was a written contract evidencing the agreement. Cameron contends, however, that there was no evidence showing an agreement, either express or implied, to share profits.

In this case the parties admittedly contemplated building additional airplanes for sale to the public * * *. The parties' written agreement also expressly recognized that additional planes would be built for sale. For example, the agreement provided that Cameron would provide computerized documentation and lab test results on composite parts he manufactured to Anderson "and future aircraft purchasers," and Anderson was to "develop an inspection and documentation process on the first two airplanes, and all future airplanes purchased." The agreement further provided that construction of "all appliances" to be used in the manufacturing process "will be such that they can be used for multiple year production runs."

* * * *

We conclude the * * * court did not err in determining that Cameron and Anderson had entered into a joint venture.

DECISION AND REMEDY • The Supreme Court of North Dakota affirmed the lower court's decision. Cameron and Anderson had entered into a joint venture, and SPW was entitled to possession of the plane.

THE LEGAL ENVIRONMENT DIMENSION • On what basis might Cameron maintain a suit against Anderson?

WHAT IF THE FACTS WERE DIFFERENT? • How might the outcome of this case have been different if Cameron had been merely an aircraft parts supplier, with his only profit to be from the sale of components to Anderson?

DIFFERENCES FROM PARTNERSHIPS Joint ventures differ from partnerships in several important ways. The members of a joint venture have less implied and apparent authority than the partners in a partnership. In part, this is because a joint venture is typically created for a single project or series of transactions, whereas a partnership usually (though not always) involves an ongoing business. As discussed in Chapter 37, each partner is treated as an agent of the other partners. Because the activities of a joint venture are more limited than the business of a partnership, the members of a joint venture are presumed to have less power to bind their co-venturers. In Case 38.3 above, for instance, if Anderson's loan agreement with SPW had not been directly related to the business of building vintage planes, the court might have concluded that Anderson lacked the authority to bind the joint venture. Also, unlike most partnerships, a joint venture normally terminates when the project

or transaction for which it was formed is completed, unless the members have otherwise agreed.

Syndicate

In a **syndicate**, or *investment group*, several individuals or firms join together to finance a particular project, such as the construction of a shopping center or the purchase of a professional basketball franchise. The form of such entities varies considerably. A syndicate may be organized as a corporation or as a general or limited partnership. In some instances, the members do not have a legally recognized business arrangement but merely purchase and own property jointly.

Joint Stock Company

A **joint stock company** is a true hybrid of a partnership and a corporation. It has many characteristics of

a corporation in that (1) its ownership is represented by transferable shares of stock, (2) it is normally managed by directors and officers of the company or association, and (3) it can have a perpetual existence. Most of its other features, however, are more characteristic of a partnership, and it generally is treated as a partnership. As with a partnership, a joint stock company is formed by agreement (not statute). Property usually is held in the names of the members, and the owners (shareholders) have personal liability. In a joint stock company, however, shareholders are not considered to be agents of each other, as they would be in a true partnership.

Business Trust

A **business trust** is created by a written trust agreement that sets forth the interests of the beneficiaries and the obligations and powers of the trustees. Legal ownership and management of the trust's property stay with one or more of the trustees, and the profits are distributed to the beneficiaries.

The business trust form of organization was started in Massachusetts in an attempt to obtain the limited liability advantage of corporate status while avoiding certain restrictions on a corporation's ownership and development of real property. A business trust resembles a corporation in many respects. Beneficiaries of the trust, for example, are not personally responsible for the trust's debts or obligations. In fact, in a number of states, business trusts must pay corporate taxes.

Cooperative

A **cooperative** is an association that is organized to provide an economic service to its members (or shareholders). It may or may not be incorporated. Most cooperatives are organized under state statutes for cooperatives, general business corporations, or LLCs. Generally, an incorporated cooperative will distribute dividends, or profits, to its owners on the basis of their transactions with the cooperative rather than on the basis of the amount of capital they contributed. Members of incorporated cooperatives have limited liability, as do shareholders of corporations and members of LLCs. Cooperatives that are unincorporated are often treated like partnerships. The members have joint liability for the cooperative's acts.

The cooperative form of business is generally adopted by groups of individuals who wish to pool their resources to gain some advantage in the marketplace. Consumer purchasing co-ops are formed to obtain lower prices through quantity discounts. Seller marketing co-ops are formed to control the market and thereby enable members to sell their goods at higher prices. Co-ops range in size from small, local consumer cooperatives to national businesses such as Ace Hardware and Land O'Lakes, a well-known producer of dairy products.

See *Concept Summary 38.1* below for a review of the types of special business forms discussed in this chapter.



CONCEPT SUMMARY 38.1 Special Business Forms

Concept	Description
Joint Venture	An organization created by two or more persons in contemplation of a limited activity or a single transaction; similar to a partnership in many respects.
Syndicate	An investment group that undertakes to finance a particular project; may be organized as a corporation or as a general or limited partnership.
Joint Stock Company	A business form similar to a corporation in some respects (transferable shares of stock, management by directors and officers, perpetual existence) but otherwise resembling a partnership.
Business Trust	A business form created by a written trust agreement that sets forth the interests of the beneficiaries and the obligations and powers of the trustee(s). A business trust is similar to a corporation in many respects. Beneficiaries are not personally liable for the debts or obligations of the business trust.
Cooperative	An association organized to provide an economic service, without profit, to its members. A cooperative can take the form of a corporation or a partnership.



REVIEWING

Limited Liability Companies and Special Business Forms

The city of Papagos, Arizona, had a deteriorating bridge in need of repair on a prominent public roadway. The city posted notices seeking proposals for an artistic bridge design and reconstruction. Davidson Masonry, LLC, which was owned and managed by Carl Davidson and his wife, Marilyn Rowe, decided to submit a bid to create a decorative concrete structure that incorporated artistic metalwork. They contacted Shana Lafayette, a local sculptor who specialized in large-scale metal creations, to help them design the bridge. The city selected their bridge design and awarded them the contract for a commission of \$184,000. Davidson Masonry and Lafayette then entered into an agreement to work together on the bridge project. Davidson Masonry agreed to install and pay for concrete and structural work, and Lafayette agreed to install the metalwork at her expense. They agreed that overall profits would be split, with 25 percent going to Lafayette and 75 percent going to Davidson Masonry. Lafayette designed numerous metal sculptures of salmon that were incorporated into colorful decorative concrete forms designed by Rowe, while Davidson performed the structural engineering. The group worked together successfully until the completion of the project. Using the information presented in the chapter, answer the following questions.

1. Would Davidson Masonry automatically be taxed as a partnership or a corporation?
2. Is Davidson Masonry member managed or manager managed?
3. When Davidson Masonry and Lafayette entered an agreement to work together, what kind of special business form was created? Explain.
4. Suppose that during construction, Lafayette had entered into an agreement to rent space in a warehouse that was close to the bridge so that she could work on her sculptures near the site where they would eventually be installed. She entered into the contract without the knowledge or consent of Davidson Masonry. In this situation, would a court be likely to hold that Davidson Masonry was bound by the contract that Lafayette entered? Why or why not?

DEBATE THIS: *Because LLCs are essentially just partnerships with limited liability for members, all partnership laws should apply.*



TERMS AND CONCEPTS

articles of organization 740
business trust 749

cooperative 749
joint stock company 748
joint venture 746

limited liability
company (LLC) 739
member 740

operating agreement 744
syndicate 748



QUESTIONS AND CASE PROBLEMS

38-1. Limited Liability Companies John, Lesa, and Tabir form a limited liability company. John contributes 60 percent of the capital, and Lesa and Tabir each contribute 20 percent. Nothing is decided about how profits will be divided. John assumes that he will be entitled to 60 percent of the profits, in accordance with his contribution. Lesa and Tabir, however, assume that the profits will be divided equally. A dispute over the profits arises, and ultimately a court

has to decide the issue. What law will the court apply? In most states, what will result? How could this dispute have been avoided in the first place? Discuss fully.

38-2. QUESTION WITH SAMPLE ANSWER: Special Business Forms.



Bateson Corp. is considering entering into two contracts—one with a joint stock company that distributes home products east of the

Mississippi River and the other with a business trust formed by a number of sole proprietors who are sellers of home products on the West Coast. Both contracts will require Bateson to make large capital outlays in order to supply the businesses with restaurant equipment. In both business organizations, at least two shareholders or beneficiaries are personally wealthy, but both organizations have limited financial resources. The owner-managers of Bateson are not familiar with either form of business organization. Because each form resembles a corporation, they are concerned about potential limits on liability in the event that either business organization breaches the contract by failing to pay for the equipment. Discuss fully Bateson's concern.

- For a sample answer to Question 38-2, go to Appendix I at the end of this text.

38-3. Diversity Jurisdiction and Limited Liability Companies Joe, a resident of New Jersey, wants to open a restaurant. He asks Kay, his friend, an experienced attorney and a New Yorker, for her business and legal advice in exchange for a 20 percent ownership interest in the restaurant. Kay helps Joe negotiate a lease for the restaurant premises and advises Joe to organize the business as a limited liability company (LLC). Joe forms Café Olé, LLC, and with Kay's help, obtains financing. Then, the night before the restaurant opens, Joe tells Kay that he is "cutting her out of the deal." The restaurant proves to be a success. Kay wants to file a suit in a federal district court against Joe and the LLC. Can a federal court exercise jurisdiction over the parties based on diversity of citizenship? Explain.

38-4. Fiduciary Duties Westbury Properties, Inc., and others (collectively, the Westbury group) owned, managed, and developed real property. Jerry Stoker and the Stoker Group, Inc. (the Stokers), also developed real property. The Westbury group entered into agreements with the Stokers concerning a large tract of property in Houston County, Georgia. The parties formed limited liability companies (LLCs), including Bellemeade, LLC (the LLC group), to develop various parcels of the tract for residential purposes. The operating agreements provided that "no Member shall be accountable to the [LLC] or to any other Member with respect to [any other] business or activity even if the business or activity competes with the [LLC's] business." The Westbury group entered into agreements with other parties to develop additional parcels within the tract in competition with the LLC group. The Stokers filed a suit in a Georgia state court against the Westbury group, alleging, among other things, breach of fiduciary duty. What duties do the members of an LLC owe to each other? Under what principle might the terms of an operating agreement alter these duties? In whose favor should the court rule? Discuss. [*Stoker v. Bellemeade, LLC*, 272 Ga.App. 817, 615 S.E.2d 1 (2005)]

38-5. Limited Liability Companies A "Certificate of Formation" (CF) for Grupo Dos Chiles, LLC, was filed with the Delaware secretary of state in February 2000. The CF named Jamie Rivera as the "initial member." The next

month, Jamie's mother, Yolanda Martinez, and Alfred Shriver, who had a personal relationship with Martinez at the time, signed an "LLC Agreement" for Grupo, naming themselves "managing partners." Grupo's business was the operation of Dancing Peppers Cantina, a restaurant in Alexandria, Virginia. Identifying themselves as Grupo's owners, Shriver and Martinez borrowed funds from Advanceme, Inc., a restaurant lender. In June 2003, Grupo lost its LLC status in Delaware for failing to pay state taxes, and by the end of July, Martinez and Shriver had ended their relationship. Shriver filed a suit in a Virginia state court against Martinez to wind up Grupo's affairs. Meanwhile, without consulting Shriver, Martinez paid Grupo's back taxes. Shriver filed a suit in a Delaware state court against Martinez, asking the court to dissolve the firm. What effect did the LLC agreement have on the CF? Did Martinez's unilateral act reestablish Grupo's LLC status? Should the Delaware court grant Shriver's request? Why or why not? [*In re Grupo Dos Chiles, LLC*, — A.2d — (Del.Ch. 2006)]

38-6. Limited Liability Companies A limited liability company (LLC) sold a Manhattan apartment building that it owned. The owners of 25 percent of the membership interests in the LLC filed a lawsuit on behalf of the LLC—called a derivative suit—claiming that those in majority control of the LLC had sold the building for less than its market value and had personally profited from the deal. The trial court dismissed the suit, holding that the plaintiffs individually could not bring a derivative suit "to redress wrongs suffered by the corporation" because such actions were permitted only for corporations and could not be brought for an LLC. An intermediate appellate court reversed, holding that derivative suits on behalf of LLCs are permitted. That decision was appealed. A key problem for the court was that the state law governing LLCs did not address the issue. How should such matters logically be resolved? Are the minority owners in an LLC at the mercy of the decisions of the majority owners? [*Tzolis v. Wolff*, 10 N.Y.3d 100, 884 N.E.2d 1005 (2008)]

38-7. CASE PROBLEM WITH SAMPLE ANSWER: Joint Venture.

 Holiday Isle Resort & Marina, Inc., operated four restaurants, five bars, and various food kiosks at its resort in Islamorada, Florida. Holiday entered into a "joint-venture agreement" with Rip Tosun to operate a fifth restaurant called "Rip's—A Place for Ribs." The agreement gave Tosun authority over the employees and "full authority as to the conduct of the business." It also prohibited Tosun from competing with Rip's without Holiday's approval but did not prevent Holiday from competing. Later, Tosun sold half of his interest in Rip's to Thomas Hallock. Soon, Tosun and Holiday opened the Olde Florida Steakhouse next to Rip's. Holiday stopped serving breakfast at Rip's and diverted employees and equipment from Rip's to the Steakhouse, which then started offering breakfast. Hallock filed a suit in a Florida state court against Holiday. Did Holiday breach the joint-venture agreement? Did it breach the duties that joint venturers owe each other? Explain. [Hallock

v. Holiday Isle Resort & Marina, Inc., 4 So.3d 17 (Fla.App. 3 Dist. 2009)]

- To view a sample answer for Problem 38-7, go to this book's Web site at www.cengage.com/blaw/clarkson, select "Chapter 38," and click on "Case Problem with Sample Answer."

38-8. LLC Dissolution Walter Van Houten and John King formed 1545 Ocean Avenue, LLC, with each managing 50 percent of the business. Its purpose was to renovate an existing building and construct a new commercial building. Van Houten and King quarreled over many aspects of the work on the properties. King claimed that Van Houten paid the contractors too much for the work performed. As the projects neared completion, King demanded that the LLC be dissolved and that Van Houten agree to a buyout. Because the parties could not agree on a buyout, King sued for dissolution. The trial court enjoined (prevented) further work on the projects until the dispute was settled. As the ground for dissolution, King cited the fights over management decisions. There was no claim of fraud or frustration of purpose. The trial court ordered that the LLC be dissolved, and Van Houten appealed. Should either of the owners be forced to dissolve the LLC before the completion of its purpose—that is, before the building projects are finished? Explain. [In re 1545 Ocean Avenue, LLC, 893 N.Y.S.2d 590 (N.Y.A.D. 2 Dept. 2010)]

38-9. A QUESTION OF ETHICS: Limited Liability Companies.



Blushing Brides, LLC, a publisher of wedding planning magazines in Columbus, Ohio, opened an account with Gray Printing Co. in July 2000. On behalf of Blushing Brides, Louis Zacks, the firm's member-manager, signed a credit agreement that identified the firm as the "purchaser" and required payment within thirty days. Despite the agreement, Blushing Brides typically took up to six months to pay the full amount for its

orders. Gray printed and shipped 10,000 copies of a fall/winter 2001 issue for Blushing Brides but had not been paid when the firm ordered 15,000 copies of a spring/summer 2002 issue. Gray refused to print the new order without an assurance of payment. On May 22, Zacks signed a promissory note payable to Gray within thirty days for \$14,778, plus interest at 6 percent per year. Gray printed the new order but by October had been paid only \$7,500. Gray filed a suit in an Ohio state court against Blushing Brides and Zacks to collect the balance. [Gray Printing Co. v. Blushing Brides, LLC, __ N.E.2d __ (Ohio App. 10 Dist. 2006)]

- Under what circumstances is a member of an LLC liable for the firm's debts? In this case, is Zacks personally liable under the credit agreement for the unpaid amount on Blushing Brides' account? Did Zacks's promissory note affect the parties' liability on the account? Explain.
- Should a member of an LLC assume an ethical responsibility to meet the obligations of the firm? Discuss.
- Gray shipped only 10,000 copies of the spring/summer 2002 issue of *Blushing Brides'* magazine, waiting for the publisher to identify a destination for the other 5,000 copies. The magazine had a retail price of \$4.50 per copy. Did Gray have a legal or ethical duty to "mitigate the damages" by attempting to sell or otherwise distribute these copies itself? Why or why not?

38-10. SPECIAL CASE ANALYSIS: Limited Liability Companies.

Go to Extended Case 38.2, *ORX Resources, Inc. v. MBW Exploration, LLC*, 32 So.3d 931 (2010) on pages 742 and 743. Read the excerpt and answer the following questions.

- Issue:** What was the main issue in this case?
- Rule of Law:** What rule of law did the court apply?
- Applying the Rule of Law:** Describe how the court applied the rule of law to the facts of this case.
- Conclusion:** What was the court's conclusion?



LEGAL RESEARCH EXERCISES ON THE WEB

Go to this text's Web site at www.cengage.com/blaw/clarkson, select "Chapter 38," and click on "Practical Internet Exercises." There you will find the following Internet research exercises that you can perform to learn more about the topics covered in this chapter.

Practical Internet Exercise 38-1: Legal Perspective

Limited Liability Companies

Practical Internet Exercise 38-2: Economic Perspective

Joint Ventures